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OVERSIGHT HEARING ON EXPENSING STOCK OPTIONS: SUPPORTING AND STRENGTHENING THE INDEPENDENCE OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

HEARING

BEFORE THE

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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OVERSIGHT HEARING ON EXPENSING STOCK OPTIONS: SUPPORTING AND STRENGTHENING THE INDEPENDENCE OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

TUESDAY, APRIL 20, 2004

U.S. SENATE,
FINANCIAL MANAGEMENT, THE BUDGET, AND
INTERNATIONAL SECURITY SUBCOMMITTEE,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:33 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senators Fitzgerald, Bennett, Akaka, Levin, and Lieberman.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. This meeting will come to order. I would like to thank all of the witnesses who are here today to testify. Some of you came very long ways and made special arrangements in otherwise very busy schedules to be here, and we definitely appreciate that very much.

This oversight hearing is to examine the new Financial Accounting Standards Board rule which will require companies to expense an estimate of the value of stock option compensation to their employees and management. I will state up front that I agree with FASB's new rule and that I favor it.

Several bills regarding this issue have been introduced in Congress, both in the House and the Senate, and there is going to be a hearing on the House side tomorrow to examine some of those bills. We will hear today from Senator Enzi, who is a proponent of one of these bills. The bills in varying forms would move to disallow FASB's new rule or to mandate the treatment of stock option compensation for accounting purposes as a matter of Federal law.

I disagree with those bills, and I oppose them for two reasons: One, I agree with the new FASB rule, although I think it could be stronger. I think it is actually thoroughly permissive, but I nonetheless support it. But two, I believe that political interference with our private sector standards accounting board is a dangerous precedent, and one can think of all sorts of other areas in which we could follow this precedent. What if Congress started usurping the authority of the Food and Drug Administration to allow a new pharmaceutical to be introduced on the market? I think it is a bad idea for politicians in the House and the Senate to be substituting political decisions for an expert agency, or in this case, an expert private sector accounting standards board.

We have been down this road before. Back in 1993–94 FASB proposed a new rule that would have required the expensing of stock option compensation. At that time Senator Lieberman introduced a resolution in the Senate which condemned FASB's new rule. I think the vote was 88 to something. It was very lopsided in favor of Senator Lieberman's resolution. And a separate bill was introduced that would have effectively put FASB out of business if they did not back down from their new rule that would have required the expensing of stock options. I think Congress' interference with that 1993–94 proposal of FASB resulted in disastrous consequences.

One of my most vivid recollections in my last 5 plus years in the Senate was sitting in on the Enron hearings in the Commerce Committee, where we saw a company which had its top 29 executives cash in 1.1 billion in stock option compensation in the months immediately prior to the company's stock market collapse and eventual bankruptcy. I think that the Senate opened the floodgates to an anything goes accounting mentality in the late 1990's, and many other companies wound up like Enron, Global Crossing, WorldCom, and so forth.

Opponents of the new FASB rule say that it is difficult to estimate the value of options. I am not sure I really agree with that. I think options can be sold for cash which makes them as good as cash. Warrants are similar if not functionally the same as options, and they are valued and sold all the time. Options on stocks are traded on markets all over the world. In Chicago we have the world's largest option exchange, the Chicago Board Options Exchange. My guess is that many executives who have copious amounts of options sometimes assign huge values to them on their own personal financial statements when they go to borrow from a bank. In fact, as a former banker, I recall seeing financial statements where executives holding large amounts of options would list them as a substantial asset on their personal financial statements.

In any case, it is difficult to value a lot of other things for which we require companies to account. It is certainly difficult to estimate pension liabilities, the value of derivative positions. If you are a bank, it is very difficult and a matter of imprecision to estimate what your loan loss reserve should be. Impairment of goodwill is very difficult to assess, and even the age-old question of what is the useful life of plant and equipment. That is a very difficult accounting decision. Yet no one argues that for these other items, difficulty to estimate gives a company license to pretend that these expenses do not exist either.

Opponents say that stock options require no cash outlay by a company and that they therefore need not be expensed. But depreciation, for example, requires no cash outlay either, and no one argues that we should not try to account for the real expense of the using up or the exhausting of plant and equipment that a company will have to replace. Furthermore, large amounts of stock options often later necessitate large cash outlays. Companies sometimes have to use more cash on share repurchases to stem shareholder dilution than they would have on cash compensation for their employees.

Opponents say stock options are not a real expense to a company. If that is so, why do we allow companies to take a tax deduction for the expense of issuing stock options? If the opponents were consistent in their thinking, they would support changing the current IRS rules which allow for the tax deductibility of stock option compensation.

Opponents say that requiring options to be expensed would penalize the earnings of young promising companies, and thereby make it more difficult for such companies to survive and succeed. But as Warren Buffett has written, “Why then require cash compensation to be recorded as an expense given that it too penalizes the earnings of young promising companies?” Going further, Mr. Buffett asks, “Why not allow companies to pay all of their expenses in options and then pretend that these expenses don’t exist either?” In fact, I know that many companies have in fact paid a lot of their bills in options. I have talked to a lot of law firms in Chicago that took stock options in lieu of cash in the late 1990’s for their legal bills.

I would like to focus for just a moment on the shareholder dilution impact of stock options. Last night it occurred to me to pull out the classic 1934 edition of “Security Analysis” by Benjamin Graham and David Dodd. I looked to see if they had anything in there about stock options, and they do in fact have a whole section on what in 1934 they called “stock option warrants,” which seem effectively the same thing. They said stock option warrants were frequently paid to managers or insiders in companies or to promoters of stock. In the 1920’s and early 1930’s it was common when someone would sell your stock, you would give them stock option warrants as compensation. Benjamin Graham and David Dodd, I think, are very eloquent in describing what the effect is when companies issue options.

In a company that has common shares only and no options, the common shareholders will capture 100 percent of any future rise in the value of the company. Common shareholders have an inherent right to the future enhancement or improvement in the value of a company. When you issue options, you are allowing someone else a claim on the future enhancement in the community that is diluting the formerly 100 percent claim on the future enhancement or growth in the company that the shareholders had. If a company’s prospects for future revenue and earnings growth are strong, the value that is taken away from common shareholders by issuing stock options and given to the option holders can be quite substantial. In fact, if enough stock options are issued, nearly all of the common shareholders’ stake in the future rise in the value of the company can be taken away from them. From my standpoint, there is nothing inherently wrong with taking a share of the future rise in the growth of a company away from the shareholders and giving it to the management or the employees or someone else. There is nothing inherently wrong with that. In fact, when we pay cash compensation, you are taking cash away from the shareholders and giving it to someone else.

What troubles me is that this taking away, this subtraction from the shareholders' interest, is not disclosed to the shareholders or to other investors who may be looking at this. The trouble is that current accounting standard do not require that the taking away of value from the shareholders by virtue of the issuance of stock options be fully disclosed. Companies are not now required to reflect the expense of issuing options on their income statements. Moreover, the dilution of shareholders' claims to the earnings of the company is only disclosed for so-called "in the money" options, but is not required to be disclosed for options that have been issued and are not yet in the money.

Benjamin Graham and David Dodd had a very simple way of looking at this. They said that the value of common stock plus the value of stock options equals the value of the common stock alone if there were no stock options. Thus, the way they put it, when you give stock options to someone, you are taking away something of value from the shareholders and this needs to be reflected. It should be reflected. If I could just read a paragraph from this book because Benjamin Graham went on to describe stock option warrants as a very dangerous device for diluting stock values. "The stock option"—and he refers to it as the option warrant. I am just going to call it the stock option. "The stock option is a fundamentally dangerous and objectional device because it affects an indirect and usually unrecognized dilution of common stock values. The stockholders view the issue of warrants with indifference, failing to realize that part of their equity in the future is being taken away from them. The stock market, with its usual heedlessness, applies the same basis of valuation to common shares whether warrants or stock options are outstanding or not. Hence, options may be availed of to pay unreasonable bonuses to promoters or other insiders without fear of comprehension or criticism by the rank and file of stockholders. Furthermore, the option device facilitates the establishment of an artificially high aggregate market valuation for a company's securities, because with a little manipulation large values can be established for a huge issue of options without reducing the quotation of common shares."

Under current rules, the financial statements of companies that do not expense stock option compensation are, in my judgment, fictitious. The Financial Accounting Standards Board's proposed new rule would make earnings reports more accurate and would move financial statements from the fiction to the nonfiction section of the public domain. When it comes to stock options, expensing them should not be an option. Truth in financial reporting should be mandatory.

Finally, in closing, I would like to note that there were many companies lobbying furiously in support of the bills that would overturn FASB's new rule. They are all over. Lobbyists are swarming the halls of the Capitol, lobbying furiously. We asked several of them to appear before our Subcommittee and explain their views in public. None of them was willing to do so. I think the fact that none of them was willing to appear publicly and explain why the company is in favor of the bills suggests that they are sheepish about what they are doing, and that perhaps deep down, they too recognize the unwholesomeness of the fiction that they are hoping to perpetuate.

Without further ado, I would like to turn it over to our Ranking Member, Senator Akaka from Hawaii. Senator Akaka, thank you for being here.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. It is always a pleasure to work with you, and I want to commend you for conducting this hearing today.

I want to add my welcome to our friends and colleagues, Senator Enzi from Wyoming and Senator Boxer from California, and also our witnesses today.

Mr. Chairman, Enron, WorldCom and other corporate governance failures demonstrate the dangers of not having independent accounting and auditing standards. The landmark Sarbanes-Oxley accounting reform and legislation included a provision that strengthened the independence of the Financial Accounting Standards Board, FASB, by providing a more secure funding mechanism through mandatory assessments on publicly-traded companies. FASB is intended to be independent and make their accounting rules on the basis of its judgment.

Now that FASB has proposed that all forms of share-based payments to employees, including stock options, be treated the same, the same as other forms of compensation by recognizing the related costs in the income statement, the reinforced independence of FASB will be tested.

If Congress interferes with the FASB proposal, the dangerous precedent of intervention into accounting standards will be set. Congressional interference is detrimental to the independent nature of FASB, and accounting treatment of stock options is a matter best left to FASB to determine.

We must have an independent organization establishing standards of financial accounting and reporting in an open environment that is both fair and objective. These standards are essential to investors having access to transparent and understandable information.

The Securities Exchange Act of 1934 provides the Securities and Exchange Commission with authority over financial accounting and reporting standards for publicly-held companies. Throughout its history, the SEC has relied on the private sector for this critical function. We must protect the integrity of the standards for developing the process and exercise Congressional restraint on this matter to ensure that FASB is allowed to pursue policies that it considers to be in the best interest of the public.

I thank you, Mr. Chairman, for this hearing, and look forward to the witnesses' testimony.

Senator FITZGERALD. Thank you, Senator Akaka. Senator Bennett.

OPENING STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman. I appreciate you holding the hearings.

This is an issue that has been with us a long time, and it is an issue that does not seem to go away and does not seem to get resolved, and I am not quite sure I understand why, because there are good people of good faith on both sides of the issue. Let me outline that I am in favor of expensing stock options. Let me state that I am in favor of FASB independence, and agree that Congress should not be the one to be making accounting standards.

Having said both of those things, and feeling very strongly about both of those things, I think FASB has missed the boat badly on this particular issue and is in danger of doing significant harm to our economy, and that raises the question of whether or not policy makers in the Congress should be heard, not because I do not believe in FASB independence and not because I am not in favor of expensing stock options. But I go back to the fundamental rule of medicine, which is do no harm, and there is a potential here for significant harm.

I think the reason that there is this gulf between your position, Mr. Chairman, and my concern, is that we are assuming that a stock option is a stock option is a stock option, and they are clearly not. I am glad you quoted from the 1934 book, Mr. Chairman, because it represented an attitude in 1934 that all of these things are created equal, and they are either good or bad. They should be either expensed of not expensed. They are very clearly, in today's economy and in today's corporate world, nowhere near created equal. The kind of stock option that you were talking about, Mr. Chairman, which you said can be sold as cash, and you talked about a market for options in your home State of Illinois, is not a definition of the kind of stock option that has given rise to the concern here.

Let me give you an example to illustrate this. The kind of stock option that can be traded immediately upon being granted, obviously has a significant value and a market, not that this kind exists, but theoretically a stock option that is exercisable only in 30 years has no value whatsoever. Well, nobody issues stock options that vest in 30 years, but I put those two as to outside parameters of where we are. There are people who give options that vest in 3 years and options that vest in 5 years, and options that vest longer period of time that are obviously on this continuum and somewhere away from the options that vest the day they are granted.

When I was working for a New York Stock Exchange listed company in my youth and got some stock options, they were vested the day I received them, and back in the 1960's that was the norm, and therefore, a statement that they ought to have been expensed, to me was a logical statement. Today that is no longer the norm. Today you have these many gradations of the kind I have described, and so as I say, I am in favor of an expensing statement with respect to options, and I am in favor of FASB's independence, but I am tremendously disappointed that from all of the comments FASB has received from companies that extend options that vest at different times and have clearly different values, have received no consideration whatsoever in the FASB rule that has come down. Maybe I just do not understand the rule and that is why I am here at the hearings, but there is no question in my mind that the use of stock options in creative ways that an author in 1934 never contemplated has created significant economic value in our overall economy in ways that cannot be measured by either of the two methods that FASB had adopted.

And to come back to the fundamental question that you raise, Mr. Chairman, where I am 100 percent in agreement with you on the principle, but in disagreement with you on the outcome. We want our financial statements to be accurate. We want our financial statements to record what is happening in the marketplace, and in my view, a financial statement that values an option that does not vest for 5 years at the same price as an option that vests in 24 hours is a financial statement that is inaccurate and misleading, and therefore, a problem for our investors.

As I have talked to people on Wall Street about this, they have said, well, we are smart enough to figure out the real impact of these options, and we will ignore the article value being attached to these options by FASB because we understand that that information is wrong. So therefore, this whole thing will be a nullity. If that is the case, why in the world are we doing it if it is going to be a nullity?

I have not signed on to Senator Enzi's bill. I have some problems with Senator Enzi's bill, but I have real problems with the way this whole thing has come down to an either/or, yes, you are in favor, no, you are not; yes, they should, no, they should not. I will sign up with the "yes, they should" guys as long as we understand that an option is not necessarily an option is not necessarily an option. Just because it has the same name, by no means says it has the same value. You have to look at the details of the option and value it according to those details before I will be comfortable with the position that FASB has taken.

Thank you very much.

Senator FITZGERALD. Senator Bennett, thank you. Senator Levin, I believe you were here first.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman, and thank you for holding these hearings. It is a very significant subject that we are discussing here today, and there is a long history to it. As we all know, 10 years ago when the effort was made by FASB to address this issue in the way that they felt was the proper way to do it as an independent standard-setting body, the political pressure was so heavy that they had to back off, and I admire FASB for doing what they think is the right thing to do, and I am going to do everything I can to protect that independence.

It is one of the toughest accounting issues that they have had in their history, but I think for us to intervene here and to say that we know better than they do how to set an accounting standard here in the Congress, would be to go in exactly the opposite direction as Sarbanes-Oxley which was to try to increase the independence of FASB, as Senator Akaka said, by giving it an independent source of revenue.

The issue for me is not whether or not Congress is for or against stock options any more than whether or not we are in favor of bonuses or other forms of incentive pay. Those other forms of incentive pay, no matter how conditional they are, are all treated as expenses. They are all valued one way or another, the best way that you can. As the Chairman said, there are many things that are valued that are very difficult to value, but there are ways of valuing, the best way that accountants can figure out how to do it. There is an independent standards board to set those rules. Without that independence we are going to be politicizing accounting rules around here which is the worst thing we can do, as far as I am concerned, for this market.

Stock options, since the 1980's, have provided the majority of CEO pay. Every year since then the CEO compensation has gone up, good times and bad, while leaving average worker pay further and further behind. JPMorgan once said CEO pay should not exceed 20 times the average worker pay. In 1990 the pay gap between CEOs and average workers was at 100 times the pay of an average worker. Average CEO pay in this country is now 300 times the average worker pay. Stock options are the largest single factor in that pay gap. They operate as stealth compensation because most U.S. companies do not show stock option compensation as an expense on their books. Those companies do deduct stock option pay as an expense on their tax returns. That is the double standard. That is the gimmick that allows companies to show a huge compensation expense deduction on their tax returns but zero expense on their company books. Stock options are the only form of compensation that companies are allowed to deduct as an expense on their tax returns, although they do not appear as an expense on their books. There are many additional forms of compensation which are very difficult to value, as Senator Bennett pointed out, that are nonetheless valued as an expense on the company's books. So there is only one exception, and that is stock options. It is not because of the difficulty either. It is because of the political pressure against doing what the accounting board has long ago determined was the only way that you could properly reflect compensation expenses on a company's books, and that is to show it as an expense.

FASB wants to end that double standard, and it seems to me that we should not intervene and say that somehow or other we know better than FASB. The International Accounting Standards Board, whose standards affect 90 countries, is now requiring stock option expensing. Canada began requiring stock option expensing this year. A 2002 survey of financial experts by the Association for Investment Management and Research found out that more than 80 percent support stock option expensing. All four major accounting firms also favor expensing.

There are many arguments that have been used against it, and I am going to ask that part of my statement, addressing those arguments, be made part of the record, Mr. Chairman.

Senator FITZGERALD. Without objection.

Senator LEVIN. One claim which I will spend one minute addressing is that somehow or other if we allow FASB to proceed independently that is going to depress the share prices of individual companies but also damage the stock market or the economy as a whole, and well-respected financial analysts disagree. Goldman Sachs's Global Equity Research recently issued a report supporting stock option expensing and said: "We do not expect a material impact on the share prices of most firms." UBS Investment Research said that expensing is a "long past due change," and "medicine for the long-term health of companies and investors. It will shed light on the true profitability of many companies, helping to separate those that deserve investor capital from those that do not."

Merrill Lynch says the argument that expensing options will harm U.S. technology leadership and job creation is based on "the following faulty logic. U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements." They went on, "One might as well argue that money spent on R&D should not count as an expense because it provides employment and helps industries advance."

There is one additional point I want to make, and that has to do with the Enron investigation. I was chairing the Permanent Subcommittee on Investigations when we had the hearings into Enron, and even though I do not think Congress should be substituting its judgment on accounting standards, because I do not think we are the right people to do it, we sure as heck can reflect our experience when it comes to investigations of Enron. I could not figure out how it was that Enron executives could be cooking the books, making loans, for instance, look like income, and not run into the problem of their books showing these huge revenues which therefore inflate their stock price, which therefore make their huge amount of options worth more, but not have to worry about paying taxes on those revenues.

How is it that somehow or another an executive could figure out that we could show phony inflated revenue over here but not worry about coughing up the bucks to pay Uncle Sam the income taxes on those revenues which we show on our books? This is a little known but a very important part of Enron. The answer was those same stock options that were used to enrich those executives in a company that went bankrupt. Those stock options, because they are taken as a tax deduction, allowed Enron, 4 out of 5 years, to pay no taxes despite huge apparent earnings shown on their books. Just the year they went bankrupt, CEOs at Enron took home $123 million from exercising stock options, the same year that so many lost their life savings.

These stock options played a very vital but yet unrecognized role in the Enron scandal, and it was part and parcel of that scandal. It probably could not have happened but for the role of stock options being used as a tax deduction.

For the last 5 years before it declared bankruptcy, from 1996 until the year 2000, while Enron was telling the world it was earning these huge revenues, and claiming a 5-year U.S. profit of $1.8 billion, the analysis of Enron's public filings by the Citizens for Tax Justice, showed that they deducted $1.7 billion in stock option compensation from its tax returns as a business expense.

I think we ought to support the independence of FASB and we ought to base that, first, on their independence, and our determination hopefully to reflect their courage with our own courage; but second, we ought to base it on the experience that we have recently had with Enron that shows that the role of stock options is more than just giving huge amounts of grants mainly to executives, not exclusively, but probably 90 to 95 percent overall to executives, but also to permit the kind of deceptive accounting practices to occur without being seen for what they are, which is deceptive accounting practices that made Enron look a lot better than it really was.

Thank you, Mr. Chairman.

[The prepared statement of Senator Levin follows:]

PREPARED STATEMENT OF SENATOR LEVIN

Beginning in 2001, a wave of corporate scandals engulfed the U.S. business world. Enron, Aldephia, Quest, Tyco, Worldcom—an alphabet of corporate misconduct undercut investor confidence in our financial systems, our markets and our financial regulators. To stop the wrongdoing and restore investor confidence, Congress held hearings, issued reports, and enacted landmark legislation, the Sarbanes-Oxley Act of 2002. Our work focused in particular on halting the accounting abuses infecting so many corporate books. Among other measures, we created a new Public Company Accounting Oversight Board, required companies to disclose material off-balance sheet transactions, and strengthened the independence of the private sector body that sets U.S. accounting standards, the Financial Accounting Standards Board, or FASB, by providing it with independent funding.

Today, because FASB has finally tackled one of the toughest accounting issues in its history by proposing to require companies to treat stock option compensation as an expense in their financial statements like all other forms of compensation, opponents of stock option expensing want Congress to override FASB's independent judgment, politicize the standard-setting process, and roll over FASB's independence. To do so would be to undermine key accounting reforms, signal that accounting maneuvers to prop up earnings is still acceptable, and turn our backs on the lessons of Enron. It would be a grave mistake.

The issue isn't whether Congress is for or against stock options, any more than whether we favor bonuses or other forms of incentive pay, but whether FASB should be overriden when it determines that stock option pay should be accounted for on company books as an expense, just like every other form of compensation. All other forms of compensation—salaries, cash bonuses, stock grants, stock appreciation rights, golden parachutes, retirement pay—appear as an expense on a company's books. The only exception has been stock options. The issue today is whether FASB will be allowed to maintain its independence when it decides to eliminate that exception and treat stock options as an expense, like all other forms of compensation.

In this country, stock options have typically been provided to corporate executives. Since the 1980s, stock options have provided the majority of CEO pay, boosting CEO compensation every year through good times and bad, while leaving average worker pay further and further behind. J.P. Morgan once said that CEO pay should not exceed 20 times average worker pay. In 1990, the pay gap between CEOs and average workers was already 100 times. Last year, CEO pay at about 350 of the largest U.S. public companies averaged $8 million, a 9 percent increase over the prior year. Average CEO pay in this country is now 300 times average worker pay, and stock options are the largest single factor in that pay gap.

Stock options operate as stealth compensation, because most U.S. companies don't show stock option compensation as an expense on their books. But those companies do deduct stock option pay as an expense on their tax returns. That's the double standard, the gimmick that allows companies to show a huge compensation expense deduction on their tax returns but zero expense on their books. In fact, stock options are the only type of compensation that companies are allowed to deduct as an expense on their tax returns even if the stock options never appear as an expense on their books. FASB's proposal would put an end to that double standard by requiring companies to treat stock option compensation as an expense on their financial statements.

FASB proposes taking this action because it views stock option pay as compensation. It has concluded that omitting this expense from a company's financial statement produces misleading accounting results, including making the company's earnings appear larger than they really are. FASB's view is the consensus position in the accounting field. The International Accounting Standards Board, whose standards affect 90 countries, is requiring stock option expensing beginning next year. Canada began requiring stock option expensing this year. A 2002 survey of financial experts by the Association for Investment Management and Research found that more than 80 percent support stock option expensing. All four major accounting firms also favor expensing.

But opponents predict a parade of horribles if FASB goes ahead with its plan. They predict this accounting change will stifle investment and innovation, hurt our stock markets, lead to outsourcing of high tech jobs, and wreak havoc in our economy. But a reality check shows these dire predictions are overblown. Since 2002, nearly 500 companies have voluntarily agreed to begin expensing stock options on their books. These companies represent about 20% of the number of companies on the Standard and Poor's index of companies and 39% of that index based on market capitalization. None of the predicted horribles has happened.

Let's look at some of the claims more closely.

Some opponents claim expensing stock options will stifle innovation in business. But many of the 500 companies expensing options are successful, high tech innovators like Microsoft, Netflix, and Amazon. They also include such diverse companies as General Motors, Dow Chemical, Boeing, BankOne, UPS, and Coca-Cola, each of which relies on technical innovation for business success. The CEO of Netflix, a high tech company that began expensing stock options last year, has stated: "[I]nnovation continues unabated. . . . We innovate because it thrills us, not because of some accounting treatment."

Other opponents claim that stock option expensing will lower their earnings which will, in turn, cause their stock prices to fall and devastate their investment prospects. But the facts, again, show otherwise. Just last month, a leading executive pay expert, Towers Perrin, issued a study examining 335 companies that switched to stock option expensing and found that stock performance was the same, on average, as the rest of the S&P 500 and mid-cap 400 indices. Expensing did not affect their stock prices.

Despite this factual evidence, some opponents go even farther and warn that expensing will not only depress the share prices of individual companies, but also damage the stock market or the U.S. economy as a whole. Well-respected financial analysts disagree.

—Goldman Sachs Global Equity Research recently issued a report supporting stock option expensing and stated: "We do not expect a material impact on the share prices of most firms."

—UBS Investment Research has stated that expensing is a "long past due change" and "medicine for the long-term health of companies and investors. It will shed light on the true profitability of many companies, helping to separate those that deserve investor capital from those that do not."

—Merrill Lynch says the argument that expensing options will harm U.S. technology leadership and job creation is based on "the following faulty logic: U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements. One might as well argue that money spent on R&D shouldn't count as an expense because it provides employment and helps industries advance."

—Credit Suisse First Boston Equity Research says: "We expect companies to pay closer attention to the economic cost of their stock option plans. Companies don't focus much on costs that they don't have to account for. . . . [W]e expect to see a decline in the number of options granted, potentially replaced by restricted stock, cash, incentive options, or nothing if the company had been overcompensating its employees."

—Congress' own economists at the nonpartisan Congressional Budget Office have also forecast a minimal economic impact, issuing a recent report which concludes: "[R]ecognizing the fair value of employee stock options is unlikely to have a significant effect on the economy . . . however, it could make fair value information more transparent to less-sophisticated investors."

Honest accounting, in other words, doesn't hurt the economy.

Other leaders in the financial and accounting world also support stock option expensing as good for investors and good for markets. They include Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, SEC Chairman William Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, former SEC Chairman Arthur Levitt, former Comptroller General Charles Bowsher, investors Warren Buffett, John Biggs and Pete Peterson, Nobel Prize Winners Joseph Stiglitz, Robert Merton and Myron Scholes, as well as respected groups such as the Council of Institutional Investors, the Investment Company Institute, Financial Services Forum, Consumer Federation of America, National Association of State Treasurers, Institute of Management Accountants, and The Conference Board's Commission on Public Trust and Private Enterprise.

President Bush, who doesn't support expensing stock options, nevertheless opposes Congressional interference with FASB's independent accounting judgment.

One of the newer claims of opponents is that stock option expensing will somehow force high tech companies to outsource more jobs. But a number of high tech companies, like Cisco, Dell Computers, IBM, and Intel, have already sent hundreds or thousands of jobs offshore, while opposing stock option expensing. Intel began outsourcing software research and development operations to India several years ago; in 2003, its CEO was quoted by the Indian press as saying, "I can tell you that the headcount in India will continue to grow and a lot of back office work is also coming." Cisco Systems announced in 2003 that it was "going to increase outsourcing to India in all areas" including software development, and in October announced a "China-based staffing solution" for Cisco's Global Technical Response Center.

Dell Computer, which is based in Texas, recently set up customer and technical support centers in India, China, Morocco, Slovakia, and design centers in China. It also has manufacturing plants in Brazil, Malaysia and China. Although only 36 percent of its revenue comes from overseas sales, Dell has 23,000 employees in other countries and only 22,000 here at home.

These offshoring companies are increasingly paying third world wages for high-end products and handsome profits. The stock option expensing proposal is no excuse for their outsourcing decisions: these companies don't expense their stock options. Worse, by invoking outsourcing fears to justify Congress' overriding the expertise and independence of FASB, these companies undermine the integrity of our financial reporting systems and accounting standards setting process, both of which are critical to investor confidence and long-term capital investment in U.S. companies.

Another red herring argument is that requiring stock option expensing will eliminate broad-based stock option plans and hurt average employees. The facts are to the contrary. Companies that currently offer broad-based plans to their workforce such as Home Depot, Wal-Mart, and Netflix, have already determined that they can expense options without having to terminate their stock option plans. Other companies, such as Microsoft, are replacing stock options with stock grants, but I haven't heard of their employees complaining about getting actual shares of stock. It is also important to remember that most U.S. employers, including many private companies, small businesses, and partnerships, don't offer stock option compensation to their employees; a nationwide survey by the Bureau of Labor Statistics in 2000, a banner year for stock options, found that only 1.7 percent of non-executive U.S. workers actually received any options that year. In short, honest accounting doesn't hurt average workers.

A final argument used by many opponents is that precisely estimating the value of stock options is difficult. But that's true of many items on a financial statement, from the value of goodwill to the reserves required to protect against uncollectible receivables or loans. As Warren Buffett once said, the only value that everyone agrees is incorrect for a stock option is zero.

The valuation issue, as well as other technical aspects of stock option accounting, ought to be resolved by the accounting experts, of which Congress isn't one.

What Congress can add to the debate is its understanding of the role played by stock options in too many of the corporate scandals that have come before us. I chaired the Enron hearings before the Permanent Subcommittee on Investigations and saw how the books were cooked to make loans and fake sales look like income so Enron could impress Wall Street analysts and boost its stock price. Stock options were the fuel for Enron's dishonest accounting. Enron's CEO took home $123 million from exercising stock options in the same year the company went bankrupt, and so many lost their jobs and life savings.

In addition to enriching executives, stock options played a second vital, but as yet unrecognized, role in the Enron scandal by enabling Enron to show huge paper profits without having to pay taxes on them. During our Subcommittee investigation, I wondered how Enron executives could create huge phony profits to increase the company's stock value and make their own stock options worth a fortune, without sapping the company's treasury to pay income taxes on the inflated income. I learned the answer was those same stock options, which at the same time they were enriching executives, provided Enron with a big enough tax deduction to eliminate any worries about taxes.

For the last five years before it declared bankruptcy, from 1996 until 2000, Enron told its stockholders that it was rolling in revenues, claiming a 5-year U.S. profit of $1.8 billion, according to an analysis of Enron's public filings by Citizens for Tax Justice. During those same years, Enron deducted about $1.7 billion in stock option compensation from its tax returns as a business expense—cutting its taxes by $600 million and eliminating its tax liability entirely in 4 out of the 5 years. In other words, the stock option double standard allowed Enron to dole out this form of compensation to its executives, claim a huge tax deduction, and escape paying U.S. taxes, while not showing any stock option expense on its inflated financial statements. Enron had a lot of company, by the way, in benefiting from the stock option double standard.

FASB and the folks we rely on to set accounting standards resisted enormous pressure from corporate executives when they decided to end the accounting that keeps stock options off corporate books as an expense, thereby making a company's earnings look better than they are. Hopefully, Congress will also stand up to the powerful political forces being brought to bear to overrule FASB. Congress should protect FASB's independence and its resolution of controversial accounting issues based on accounting expertise rather than political considerations. That's what we committed to do two years ago when we enacted the Sarbanes-Oxley Act, and it is critical that, in this first big test, we continue to champion, preserve, and fortify FASB's independence.

Senator FITZGERALD. Thank you, Senator Levin. Senator Lieberman.

OPENING STATEMENT OF SENATOR LIEBERMAN

Senator LIEBERMAN. Thank you, Mr. Chairman, for convening this discussion, I believe, of a seriously misunderstood problem, which is stock options and the abuse of stock options.

For much of the past decade stock options have been the subject of an intense debate, which of course, heated up particularly after the collapse of Enron and the succeeding wave of crime by executives of a number of American corporations. Many people obviously believe that the silver bullet to stop this corporate crime is to change the accounting rules for stock options, force companies to count options as expenses when they are granted, they say, and the scams and rip-offs would stop.

I wish it were that easy. Changing the accounting rules is, in my opinion, highly unlikely to change the unethical, illegal or scandalous behavior of a corporate executive who does not have the scruples to stop himself or herself from taking action that satisfies their own greed, and in the process rips off investors and employees and consumers. But I do fear that changing the accounting rules is likely to deny access to options to average workers who have done nothing wrong, and in the process put the brakes on the revolutionary democratization of capital in this country that has occurred over the last 20 years or more. I hope that our goal, and I believe our goal should be to stop the abuse of stock options, not to stop the granting of stock options. I do not believe this proposed FASB rule will do that.

Options are a very innovative way to help expand the winner's circle for millions of Americans and improve the growth and productivity of our economy. In other words, we must not throw the options baby out with the corporate corruption bath water. I believe the way to make sure we do not do that is to reform the way stock options are approved and distributed and ultimately widen access to them instead of restricting it. I have introduced legislation which I believe will do that.

As has been said, my views and interest in this subject go back more than a decade to 1993 when FASB first floated that plan to require stock options to be treated as an expense against earnings on profit and loss statements at the time they are granted. Many of us who opposed that rule change did so for two reasons. First we believed it did not make sense; it was bad accounting. Second, we were concerned that it would significantly deter the kind of entrepreneurship that grows our economy and expands the middle class. I do not think any of us were primarily motivated by a desire to compromise the independence of FASB, but if FASB is about to promulgate a rule that we think, and thought then, would have an adverse effect on a lot of people in our country and on our economy generally, I take it to be my responsibility to express that point of view. Our goal here again should be to stop the abuse of stock abuse, not their granting.

Let me go back to 1993. Why did we do that? We were never convinced that there is an accurate way to value an option on the day it is granted. I know Warren Buffett has now famously said that options are compensation and therefore compensation should be expensed. Of course options are probably compensation. I emphasize the "probably." They are a form of compensation, but the compensation occurs not when they are granted, but when they are exercised. At the extreme, options that go under water when the stock price drops below the price on the day that the options were granted never become compensation at all. They are effectively worthless, as tragically, thousands of Enron employees can tell you. We only know, as far as I understand this, options are compensation when they are exercised. I hope most people listening to this or watching it understand we are talking about two dates, the date the company says, OK, John Smith, you have got options, but then there is another day that comes, usually after a holding period required of some years, in which the options are actually exercised, they are sold. That is when they become compensation.

Incidentally, that is when the company can take as a deduction the difference between the price of stock on the day the option was granted and the price when it was exercised or sold and money was made. The employee on the date of exercise pays a tax on the difference and the company takes it as a deduction. That is the IRS. What we are talking about is accounting rules on the day that it is granted, and I continue to see no way you can actually value on that day.

I wonder if the advocates of expensing stock options could point to a single case where a company's disclosure of stock option values and cost at the time of granting, which is what they have been required to do under the FASB compromise rule since 1995, has proved to be accurate. The Enron footnotes, for example, which I have looked at, estimated stock option values and costs that proved to be wildly inflated and inaccurate because they did not anticipate the collapse in Enron's stock price that came about as a result of the corrupt behavior of some Enron executives. So that is what, in 1993, we were not convinced of, that you could value an option on the day it was granted, but here is what we were convinced of, that mandatory expensing of stock options would inhibit their use, and that would hurt a lot of people who were getting stock options, not the top executives, and it would also hurt our economy because of the role that the options play in attracting innovative employees away from big companies to start-up companies. Experience has proven that options are an effective mechanism for doing that, and for spreading wealth, because they give employees a direct stake in their companies, and of course business leaders, particularly from the high tech community, made clear that they would issue fewer options if they had to subtract their estimated value from their profits on the statement as required.

Much has changed since that original debate and vote here in the early 1990's, but I say with all respect that the problems that I have with FASB's approach have not changed. Requiring firms to predict the values of options at the time of granting still looks to me like bad accounting. I just do not know how you can do it, and I am still troubled that it would have damaging repercussions on our economy overall, on thousands of businesses or would-be start-up businesses, and certainly on millions of workers who would otherwise get these options.

To be specific, it would significantly reduce earnings for many companies with option plans, which in turn would reduce the value of their stock in particular, maybe the market in general, and business would almost certainly decide to grant fewer options. Of course, the first to be cut out would not be the top executives including the relatively small number among business executives in America who have been proven to have acted unethically or illegally in the recent wave of corporate crime. What would be hurt? The guys at the top and the women at the top would be cutting out the other workers in the company from the opportunity to have options, and that is the last thing we need now with the average income of American workers dropping.

I will give you an interesting statistic, Mr. Chairman. Just 12 years ago, around the time the first FASB debate occurred, a little bit before it, one million Americans owned stock options. Today more than 14 million people in this country hold stock options. It is astounding. And a growing number of companies, very diverse, like Staples, Intel, Wells Fargo and the Vermont Teddy Bear Company, to name a few that are diverse, offer broad-based plans that distribute most of the options to rank and file workers, not senior executives.

Are there problems with options? Yes, there are. But again, I believe the FASB rule is very unlikely to solve them and will cause its own problems. Number one problem: Too high a percentage of options are still rewarded to high-level executives. The National Center for Employee Ownership estimates, "That while the growth of broad-based options has been an important economic trend, our data nonetheless indicate that even in plans that do share options widely, executives still get an average of 65 to 70 percent of the total options granted." That is their right, but in my opinion, that is unfair, and it does contribute to the inequity in income distribution in our country. It is this skewed distribution, not the accounting, that I feel is the root of the problem. Obviously, we have seen examples where some executives, loaded up with tens of thousands of options, have engaged in the kinds of practices that have increased their earnings and their share price if cashed out at the right time, and then very often they have left the company.

To counter these abuses, I have introduced what I believe is a better, tougher stock option reform proposal, and the purpose of my legislation, if you will allow me to put it this way, is to mend, not end, stock option distribution.

First, my proposal will prohibit a company from deducting the cost of options when exercised if it does not offer the majority of those options to rank and file workers. I define that in the bill as those who make less than $90,000 a year, which is an existing standard, and are not among the firm's top 20 percent of highest-paid employees.

Second, my proposal would set a mandatory holding period for stock option grants and block top executives from selling their shares while they are employed by the company.

Third, it would require all stock option plans to be approved by a majority of shareholders, guaranteeing greater accountability and transparency.

I offer this, Mr. Chairman, as a tougher, more sweeping, and I believe ultimately more effective, response to stock option abuse and its consequences. Rather than retard the revolutionary democratization of capitalism in our country, this proposal will help accelerate it by putting more options and more wealth in the hands of more working Americans. That is a solution we can all count on, and I believe account for. Thank you very much.

Senator FITZGERALD. Senator Lieberman, thank you.

Now I would like to introduce our first two witnesses, Senator Enzi and Senator Boxer, and I understand Senator Enzi may have a scheduling conflict.

Senator ENZI. I do not.

Senator FITZGERALD. The normal tradition would be that Senator Boxer has seniority in the Senate, but she is——

Senator BOXER. Senator, that is very kind, but I think because Senator Enzi has a bill that I am very supportive of, I think it is just fine if he goes first, and I am happy to go after him.

Senator FITZGERALD. Thank you, Senator Boxer. Senator Enzi, I would just like to introduce you.

Senator Enzi is the Senator from Wyoming, and was here to testify at our recent hearing on financial literacy. Senator Enzi was elected to the Senate in 1996, and he is an accountant and former small business owner. He serves on the Committee on Banking, Housing and Urban Affairs, where he chairs the Securities and Investment Subcommittee.

Senator Enzi is the sponsor of S. 1890, the Stock Option Accounting Reform Act, which would require an issuer of registered securities to expense stock options granted to executive officers.

Senator Enzi, thank you. Welcome back to our Subcommittee, and thanks for your patience as well.

TESTIMONY OF HON. MIKE ENZI,[1] A U.S. SENATOR FROM THE STATE OF WYOMING

Senator ENZI. Thank you very much, Mr. Chairman, Senator Akaka, and Subcommittee Members, for allowing me to testify before you today.

I also want to thank Senator Boxer for all the work that she has done on the bill that we have, and all of the interest that she has shown and her knowledge in it.

[1] The prepared statement of Senator Enzi appears in the Appendix on page 73.

I would also like to associate myself with the remarks of Senator Bennett when he was talking about the independence of FASB, and the need to expense stock options.

But having said that, I am here today to speak solely on behalf of the millions of small businesses in the United States that may or may not even be aware of the proposal by the Financial Accounting Standards Board to require expensing the stock options. I have to tell you, a reporter from Wyoming today at lunch asked me if I thought my bill would pass. I said, if FASB listens once, it will not have to pass, and if they do not listen, it could be a landslide to pass it. So that is the position that I am coming from.

There are small businesses in the United States that number nearly 23 million, and they represent 99 and 7/10ths percent of the employers. They employ half of all private sector employees and they generate 60 percent of the net new jobs annually. In addition, small businesses produce 13 to 14 times more patents per employee than large patenting firms. It is not an exaggeration to state that the health and strength of our Nation's economy rests on the ability of small businesses, small businesses, to start and grow. Our Nation's entrepreneurial spirit and climate are the envy of the world. Today many countries are trying to replicate our small business system. In fact, news articles of late last year showed that China is trying to build its own Silicon Valley. You know what their business plan calls for? Stock options. Yes. We must be very careful not to cause unintended consequences that might disrupt small business and the job creation.

The reason I am here today is to voice small business concerns that I believe are being overlooked or pushed aside as not relevant to the discussion of stock option expensing. At first glance, the question of whether to expense stock options appears to be very simple and media friendly. However, before getting to the question of expensing stock options, one must first ask how those will be valued?

As the traditional saying goes, the devil is in the details. Based upon the recent proposal by FASB one must be versed in the differences between the fair value method, intrinsic value method, lattice structures, and binomial and Black-Scholes expensing valuation models. As an accountant, I found that these terms are not in the general accounting world but are unique to this particular accounting proposal. So for small business owners and their accountants that are encountering these terms for the first time, the evaluation of the FASB proposal will be daunting.

The valuation approach, as proposed by FASB, would set up small businesses to wake up in a nightmare. The proposal itself is more than 230 pages long. This is the little document that small businessmen need to wade through to be sure they are not violating the accounting standard. Rather than addressing small business concerns head on, FASB has just thrown together a series of criteria for small business to consider.

Small businesses have no choice but to hire expensive experts to delve into this voodoo valuation. Some believe that only the largest accounting firms would be able to produce the proper valuation models, and I am hearing that it could cost up to $500,000. Both small business and small accountants would be victims of the

FASB proposal. A frequent concern heard by the Governmental Affairs Committee is that small business owners are very busy building and running their businesses, and cannot pay attention to many Federal regulators in Washington, DC—I know you have heard that a lot—for this sole reason: Congress created the Regulatory Flexibility and the Small Business Regulatory Enforcement Fairness Acts. These Administrative Procedure Act laws require Federal regulatory agencies to undertake economic analysis when a proposed regulation may disproportionately burden small entities. In addition, the law requires agencies to conduct vigorous outreach and establish compliance assistance for small business.

FASB, as an independent standard setter, is not bound by the Regulatory Flexibility nor the Small Business Regulatory Enforcement and Fairness Acts. Accordingly, FASB, as a standard setter recognized by the Federal Government, should establish equivalent small business review practices for itself.

In November, I held a hearing in the Committee on Banking, Housing, Urban Development entitled "FASB and Small Business Growth." At that hearing we heard from a variety of witnesses that FASB's consideration of small business concerns on several different FASB proposals, not just stock options, several different FASB proposals, was severely deficient.

At the hearing I requested that a Small Business Advisory Committee be established by FASB to listen and address small business concerns. I envision this Subcommittee to operate in the same manner as NASD's Small Firm Advisory Board, in that all proposals would be reviewed and evaluated by the Subcommittee. I even wrote a letter to Mr. Herz and asked if that was not the case.[1] I did not get a response that said that that was not the case. But FASB has since indicated to me that the Small Business Advisory Committee would meet twice a year and would receive only proposals on an ad hoc basis.

While I am pleased that FASB has established the committee, I still have serious doubts about FASB's commitment to listening on the small business issues. For example, immediately following the hearing, FASB conducted field tests with 18 businesses on stock option expensing. None of the businesses were small businesses. Now, as FASB is rushing to implement the proposal on stock option expensing by the end of the year, I am very much concerned that small business issues will be pushed aside or not addressed at all. For example, the proposal will apply not only to publicly traded companies, but also to privately held companies. Many of these privately held companies are start-ups and very small companies, and many that I have spoken to recently have no idea that this proposal will apply to them.

In addition, FASB, without advanced warning, extended the proposal to include companies with employee stock purchase plans. Have you been talking about stock options or employee stock purchase plans? That is the smallest business thing that I know of where the mom and pop operation is trying to sell to their employees. They are going to have to pay attention to that now because

[1] The letter to Mr. Herz from Mr. Enzi, dated December 5, 2003, appears in the Appendix on page 148.

they have been included. We did not know about that. It was a surprise to me when I looked through there and found that. While some of the companies will be able to participate in the two roundtables to be held by FASB in Connecticut and California, thousands of others may not find out about the roundtables until it is too late.

In addition, the first meeting of the Small Business Advisory Committee is on May 11. However, an issue as complex as this may not be addressed fully. It is quite possible that the committee could spend all day on the proposal's glossary of terms in this 230-page book, and have very little time to discuss anything else.

For this reason, a hearing has been scheduled next week by the Committee on Small Business and Entrepreneurship that will give a limited number of small businesses a chance to discuss the proposal on stock option expensing.

As the Governmental Affairs Committee has jurisdiction over Regulatory Flexibility and Small Business Regulatory Enforcement Acts, I will leave the Subcommittee with a couple of questions that should be considered in this hearing.

First: What are the duties and responsibilities of a standard setter, recognized by the Federal Government for analyzing the economic impact of proposals? Should those duties and responsibilities rise to the level of statutory mandates of Federal agencies?

Second: What is the level of outreach that is required to ensure that small businesses throughout the country are able to participate in the standard-setting process?

Third: What is the remedy for when a small business believes that the independent standard setter gets the standard wrong for small business, or that the standard setter has completely pushed aside small business concerns? Small businesses, pursuant to the Regulatory Flexibility Act, may sue a Federal agency to set aside a rule if the small business has been unjustly aggrieved. As one of the principal authors of the Sarbanes-Oxley Act, I support an independent accounting standard setter. However, an independent accounting standard setter has to live up to a very high standard. With respect to FASB's oversight of small business concerns, I believe there is still a significant way to go.

Finally, I should mention that in today's *Wall Street Journal* there is an account of Chairman Herz conducing a conference call with institutional investors yesterday. In that call he urges institutional investors to make your views known to the people in Washington so that FASB can go forward with its proposal by the end of the year.

I thought we were in a period of comment when FASB should be encouraging everybody, and particularly small business, particularly the small businesses that do not even know they are about to have this thrust on them, to be commenting on the rule, not to be lobbying Congress not to be interested in this rule. I am really disappointed in that. That is further evidence that Chairman Herz will bypass the due process for small businesses in order to impose his will upon process. I have been trying to get some recognition of small business since this first came up, and having a little difficulty with it.

I do have an article that I would like to have made part of the record that covers that conference call.[1]

Senator FITZGERALD. Without objection.

Senator ENZI. Interestingly, Chairman Herz's call was with institutional investors, and recent news articles have shown that institutional investors, including public pension funds, readily invest in hedge funds. I find it extremely troubling that institutional and pension fund managers will invest in unregulated hedge funds, but cannot interpret stock option information that is currently available in extremely detailed notes of registered, publicly traded companies.

In addition, I also would like to introduce a very recent study on the use of stock options into the record, and that is the study of Professors Joseph Blasi and Douglas Kruse.[2] They found that stock options are widely held by true workers and middle management of many companies and not just used by executives.

Senator FITZGERALD. Without objection.

Senator ENZI. I would mention that to give you something a little more current than the 1934 book, that they have also written a book called "In The Company of Owners: The Truth About Stock Options," which I highly recommend to everybody to understand how this revolution to stock options has resulted in the kind of an economy that we have come to expect in the United States and the value that has had.

It is a matter of executive compensation. A recent article in the *Washington Post* detailed that with or without stock options, top executives will receive their compensation. Therefore, this proposal will hurt only small businesses and employees.

I thank you for this opportunity to testify.

Senator FITZGERALD. Senator Enzi, we appreciate your being here today. Thank you very much.

Senator Boxer, thank you for waiting patiently.

Senator BOXER. Mr. Chairman, you want me to try to do my testimony in 5 minutes; would that be your desire? I will try that.

Senator FITZGERALD. We will not strictly enforce that, but we would appreciate it because we have two other panels coming. Thank you.

Senator BOXER. I am going to try to do that. So first I will start off with putting my statement in the record, if that is OK with you.

Senator FITZGERALD. Without objection.

Senator BOXER. Then I will try to summarize this within 5 minutes or a minute over.

Senator FITZGERALD. That is great.

TESTIMONY OF HON. BARBARA BOXER,[3] A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator BOXER. First of all, thank you so much for this chance because this is a big issue to California, and I have been involved with it for a long time with Senator Enzi, going before that, Sen-

[1] The article from the *Wall Street Journal* entitled "FASB Chairman Calls For Investors To Speak Up On Options," appears in the Appendix on page 150.

[2] The study entitled "Corporate Governance, Executive Compensation, and Strategic Human Resource Management From 1992–2002, A Portrait Of What Took Place," by Professors Joseph Blasi and Douglas Kruse appears in the Appendix on page 212.

[3] The prepared statement of Senator Boxer appears in the Appendix on page 77.

ator Lieberman, when I was a House member and I just came over to the Senate, Senator Allen, just a whole group of us from both sides of the aisle, and I just appreciate this chance.

What I would like to do is first of all comment on the various presentations each of you has made, first of all, to rebut them in some cases or to support them in others, but second, to prove to you that I was listening to you, that I was hanging on every word.

I would start off with you, Mr. Chairman, kind of bemoaning the fact that the lobbyists did not come up here. Lobbyists should not be testifying in these meetings. I really believe that because there are lobbyists on both sides of every issue. They get paid for that and it is our job to ferret out what is in the best interest of the people, and it is our job to come up here and not their job. It would be awful, so I am sort of glad that did not happen.

Second, to Senator Bennett's point, I think he makes—he is struggling with this deal because he believes in the independence of FASB, but yet he believes what I believe, and that is, that a one-size-fits-all kind of rule could have tremendous ramifications. I am the daughter of a CPA. I love accountants, so this is nothing against the accounting profession, but they do have blinders on when it comes to policy. That is their work. It is their job. They see things in a narrow fashion, and policy is not their thing. That is fine for a lot of things, but when you are dealing with options, when you are dealing with the potential ramifications here which have been stated by Senators Bennett and Lieberman, you are dealing with serious business, and of course, very eloquently stated by my colleague.

I would agree that I do not think FASB has listened to us one bit. We gave them every chance. We had a hearing. Remember that one? What would you call it? A seminar. And we said, well, look, this does not make sense, and we went through how do you evaluate these and so on and so on. And then they just could not care. For those of you who wanted them to stick with what they came up with 10 years ago, do not worry, there is not a chance they will change to try to reach out and look at some of the ramifications of what they are doing. It is very discouraging. For me to be told, as a U.S. Senator who cares about jobs and cares about a middle class and cares about making sure there is prosperity, that I should not speak up against a group that I think is not considering the ramifications of their act, that is not a good approach with me because I think that is our job. Otherwise, things could go haywire around here, and they sometimes do.

To Senator Akaka, who mentioned Enron and WorldCom and Senator Levin who did the same, these were crooks and thieves, these people. They made a false electricity crisis in my State, Enron did. I am familiar with what they did. They spent day and night trying to thieve from people, and they did, to the extent of $11 billion that I know of. That is what it cost my consumers in Enron's case. And options are not—they should be thrown I jail. Meanwhile, what is happening, because of their acts and because some people think options was the problem, not the fact that they were thieves, then what you are saying is not only the people there are at a disadvantage because they lost their jobs, they lost their pension, they lost everything, but as a result of FASB, we are going to have a whole group of other workers, who had nothing to do with these things, being punished. That would be just the ultimate irony, being punished for the likes of Enron and WorldCom when all they want to do is get a chance at the dream.

So I hope you will think about that. After FASB gets done with their rule, the people at the top are going to get their options. Make no mistake about it. But the people that I fight for in my State, and Cisco Systems is a perfect case in point, I believe it is 95 percent of the employees there have options. So now you think you are doing this great thing to punish the fat cats, and you are hurting everybody else because the fat cats will still keep getting their options.

Let me just, because I do not want to take too much of your time, I want to give you a sample of what some of my constituents are saying, maybe the ones that voices have not been raised yet, although they have been alluded to. Bill Griffin, who works for Auto Desk in Palo Alto, wrote to the FASB, "Stock options are the last bastion of the hard-working middle manager. For 2 years the only thing that helped me pay for my two kids in college has been stock options. Without stock options mortgaging my home would have been my only option."

David Dorr from San Jose wrote to the FASB, "In my opinion, stock option compensation at Silicon Valley companies is what helped form this valley in the first place. Do not destroy it because some companies abused it by only giving options to the top."

Listen to what Kelly Simmons wrote to the FASB. Quote, "If you eliminate broad-based employee stock options from hard-working individuals like me, you are taking away more than you think. You are taking away the dream of someday owning a home here in the Silicon Valley."

So FASB got lots of these letters, but they listened to them just as much as they listened to Senator Enzi and I, and Senator Lieberman and others. So I have respect and admiration for FASB, but I do not want to put the future of our economic expansion in the hands of folks who refuse to look up from their eyeshades and see the big picture, and the big picture has an impact on hard-working people, on shareholders and people who are only just doing the right thing every single day.

Last, we have a great alternative. And by the way, I love Senator Lieberman's bill. I am going to look at it and hopefully go on it, but we have a great bill. Senator Ensign and I have worked with Senators Enzi and Reid, and others on legislation that would mandate the expensing of stock options for the top five executives at a company, but not for the options granted to rank and file workers. Start-up companies would be exempt. Let me just stop here.

It just seems like everybody is frozen into their position except for Senator Bennett, who still looks like we can grab him, one side or the other. I just hope you will think a little bit about some of your premises, those of you who are just saying no legislation interfere. If it was a small matter, that would be one thing. This is a huge matter. It is going to impact the lives of real people who really believe, and have told me—and a lot of them are women, by the way, I have to tell you—who are telling me this is their only shot at the dream, and let us not take that away because of some rule that we do not want to interfere with some group of folks who are dedicated, and I respect them, but that is not their job to worry about policy. It is our job.

Thank you very much.

Senator FITZGERALD. Senator Boxer, Senator Enzi, thank you very much. We appreciate your being here and appreciate your interest in the subject. Thank you so much for coming.

At this point we would like to invite our second panel to the witness table. We have two witnesses on our second panel. Our first witness on this panel is Robert H. Herz, who was appointed Chairman of the Financial Accounting Standards Board effective July 1, 2002. Prior to joining FASB, Mr. Herz served as PriceWaterhouseCoopers' North America Theater Leader of Professional, Technical Risk and Quality, and he was also a member of the firm's board. Mr. Herz has served as a part-time member of the International Accounting Standards Board, and has chaired the SEC Regulations Committee of the American Institute of Certified Public Accountants and the Trans-National Auditors Committee of the International Federation of Accountants. Mr. Herz has also served as a member of the FASB Financial Instruments Task Force and the American Accounting Association's Financial Accounting Standards Committee.

Our second witness is the Hon. Paul A. Volcker, the former Chairman of the U.S. Federal Reserve Board, and the current Chairman of the International Accounting Standards Committee Foundation. Mr. Volcker has nearly 30 years of distinguished service with the Federal Government, and served two terms as the Chairman of the Board of Governors of the Federal Reserve System from 1979 to 1987. More recently, Mr. Volcker served as Chairman and CEO of Wolfensohn and Company, from which he retired in 1996 upon its merger with the Bankers Trust Company. Mr. Volcker currently serves as chairman, director of, or consultant to, a number of corporations and nonprofit organizations.

Gentlemen, we deeply appreciate your taking the time to appear before this Subcommittee and we would like to invite you to offer your full written statements into the record. We can simply have them accepted as part of the record, and it would help if you could attempt to summarize your comments within 5 minutes, so that we can then proceed with questioning. Thank you.

Mr. Herz, would you please go first?

TESTIMONY OF ROBERT H. HERZ,[1] CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you, Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee.

Mr. HERZ. As you know, the FASB is an independent private sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our role in the system—that is, to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses.

[1] The prepared statement of Mr. Herz appears in the Appendix on page 80.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act, is also fundamental to our mission because our work is technical in nature and designed to provide preparers with the guidance necessary to report on their underlying business transactions.

Now, while the current efforts by certain parties to block our proposed improvements to the accounting for equity-based compensation may seem attractive to some in the short run, in the long run biased accounting standards are harmful to investors, to creditors, to the capital markets, and to the U.S. economy.

Because the actions of the FASB affect so many organizations, our decisionmaking process must be open, it must be thorough, and it must be objective, as objective as possible. And so our rules of procedure require a very extensive and public due process.

On March 31, as has been noted, we issued a proposal for public comment to improve the accounting for equity-based compensation. It covers not just stock options but a whole variety of equity-based compensation arrangements because we wanted to get consistent accounting and a level playing field between the various forms of equity-based compensation, as well as with other compensation.

The proposal was a result of a very extensive public due propose that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, consultations with our advisory councils, field visits to companies—which, by the way, did include small businesses—public and private discussions with hundreds of individuals, including users, auditors, and preparers of financial reports, valuation experts, compensation experts, and active, open deliberations at 38 public FASB Board meetings.

The Board believes that our proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including, as has been the main topic of discussion, the elimination of the existing exception for so-called fixed plan employee stock options, which, as Senator Levin remarked, are the only form of equity-based compensation that is not currently required to be recorded as an expense in the financial statements. Our proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such, and that the existing exception for fixed plan employee stock options results in reporting that ignores the economic substance of those transactions.

In that regard, I would note that when enterprises use stock options and other instruments, like long-dated stock purchase warrants, for purposes other than compensating employees—for example, to acquire goods and services, as you mentioned, Chairman Fitzgerald, to pay for legal services and the like—they have long been required to value those instruments and to properly account for them in the financial statements.

We believe the elimination of the fixed plan stock option exception is also responsive to the demands and concerns expressed by numerous hundreds of individual and institutional investors, pension funds, creditors, financial analysts, the major accounting firms, and many other parties. We also believe it will provide greater transparency and consistency in the reporting of various forms of equity-based compensation and greater comparability between enterprises that compensate their employees in different ways and between the now nearly 500 companies that have voluntarily chosen to account for the cost of employee stock options and the many others that continue not to do so.

The proposal also has a secondary benefit—an important one, I believe—of achieving much greater international comparability in the area of accounting for equity-based compensation. In that regard, as noted, our international counterpart, the International Accounting Standards Board, issued a final standard in February of this year requiring the expensing of all equity-based compensation, including all forms of stock options. The IASB standard will be followed by companies in over 90 countries beginning next year.

Our proposal includes a lengthy Notice for Recipients that highlights and describes over 20 specific issues that respondents may wish to consider in developing their comments to us, including a number of issues that focus on the proposal's measurement approach and on the special provisions that we have proposed relating to small business.

The Board also plans to hold public roundtables, four of them, with interested users, auditors, and preparers of financial reports, and valuation and compensation experts to discuss the issues raised by the proposal. We also will be discussing the impact on small businesses and their views at the inaugural meeting of our Small Business Advisory Committee in a couple of weeks.

Following the end of the comment period on June 30, we plan to redeliberate, at public meetings, the issues raised in response to our proposals. Those redeliberations will address all the key conceptual, measurement, disclosure, and cost/benefit issues raised in the comments and will include careful consideration of the input received from all parties.

Only after carefully evaluating that input at public meetings will the Board consider whether to issue a final standard. Our current plan is to complete the redeliberations and be in a position to issue the final standard in the fourth quarter of this year.

I would like to conclude my statement by noting that we have all witnessed the devastating effects and loss of investor confidence in financial information that have resulted, at least in part, from companies intentionally violating or manipulating accounting requirements. Investors, creditors, and other consumers of financial reports are continuing to demand improvements in accounting and financial reporting. The existing accounting for equity-based compensation, not just as regards CEO compensation but the basic flaw in the accounting model, has been an area of great concern, and our proposal is intended to be responsive to that concern and to what we have seen in our extensive process of looking at the economic attributes of those instruments.

Thank you, Mr. Chairman. After Chairman Volcker talks, I would be happy to respond to any questions.

Senator FITZGERALD. Thank you very much, Mr. Herz.

Mr. Volcker, thank you for being with us. You may proceed.

TESTIMONY OF HON. PAUL A. VOLCKER,[1] CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION, AND FORMER CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Well, thank you. I will just summarize my comments briefly, but let me make two preliminary statements after listening to the earlier conversation.

Expensing stock options is not about eliminating stock options. The question is how to account for them properly. And to the extent that stock options have been abused—and I have no doubt they have been abused in many cases to the extent that that abuse is related to the fact they are not accounted for, obviously that should be taken care of. That is in favor of expensing stock options. And nobody is saying in the accounting world that they must be eliminated. All we are saying is account for an expense in ways comparable to other expenses.

The other point I would make is that small business has a problem in many elaborate accounting areas. They have gotten extremely complex for big businesses, I am afraid. That is a problem, and in my responsibilities with the International Accounting Standards Committee Foundation—a cumbersome word—we are reviewing our procedures now to try to make sure that small businesses and their views and problems are sufficiently taken care of in determining accounting standards.

I am the Chairman of the Trustees of the International Accounting Standards Committee Foundation. I emphasize that because our responsibilities are to appoint members of the board that make the decisions, not to make the decisions itself, but it is also our responsibility to satisfy ourselves that there has been sufficient consultation and due process before the board we appoint does arrive at conclusions.

I have been interested in this. The only reason that I have agreed to become Chairman of the Foundation is that I think commonality in international accounting standards is a good thing. The world is globalizing. We are not going to stop that. The financial world is globalizing. If we are going to have an efficient system of international capital, you better have a common set of accounting standards. And, in part, that is what is at issue in this debate.

As Mr. Herz just mentioned, the International Board has decided a standard on expensing stock options. That is somewhat controversial in other areas of the world, but not to the extent it is here. I have every reason to believe the Europeans will adopt that standard and it will become compulsory in Europe and most other major countries in the next year.

Now, oddly enough, or maybe interestingly enough, there is another accounting standard that the International Board has put out that is extremely controversial in Europe, and it is not been yet adopted by the European Union, and there is intense political pressure in the European Union to reject that standard, so-called IAS 39, which involves, importantly, accounting for derivatives. In the European world, derivatives are not accounted for, and this standard is an important initiative to bring that important area of ac-

[1] The prepared statement of Mr. Volcker appears in the Appendix on page 86.

counting on the books. It is not controversial in the United States because the standard already exists in the United States. It was controversial when it was applied in the United States some years ago, but American companies are now used to it, and I don't think anybody is suggesting that the United States should abandon that standard.

Now, I point this out because we have political pressures on the standard setters, two different standards from different directions. And I think you have to ask yourself what are the prospects for finally achieving coherent, consistent, high-quality international standards if the political authorities, whenever they find one they don't like, reject it. And that will obviously have a kind of snowballing effect. You will lose discipline in maintaining independence if in different cases considered important the independence is overcome.

I am sensitive to that, and in Sarbanes-Oxley, and in all my conversations with the SEC and up here on the Hill when I agreed to this assignment, I kept getting drilled into me: You must be independent, you must have a framework that protects these decisions from political "interference." That is the way our system is set up. The so-called constitution for the International Board is set up with elaborate arrangements to protect the independence. That is supposed to be part of my responsibility to protect that independence. So I feel rather strongly about it.

I think that is the essence of my statement. I don't comment on the substance of the rule. I am not supposed to. That is the Board's idea. I am supposed to respect their independence. But I do think this is very important in terms of the overall objective of getting international consistency.

Senator FITZGERALD. Mr. Volcker, thank you very much for that statement. I appreciate both of you being here.

I would just like to make a couple of statements in the way of response to some of the things other Members have mentioned in their opening remarks, or the two Senators who were testifying.

First of all, the book "Security Analysis" is still in print. I just happen to have the original edition because I wanted to buy that. You can still buy the original edition, but it has been republished and updated many times. It is one of the classic all-time books, and Benjamin Graham was updating it almost to when he died in the 1970's. Warren Buffett refers to Benjamin Graham's book, "The Intelligent Investor," which I have also read, as the single best book on investing ever. And almost all of his books, as far as I know, are still in print and selling widely. It is just that I only have the classic edition on my home bookshelf, and that is why I cite it. There may well be some better language that I could have referred to in more recent editions.

Also, I do, of course, recognize that the options that are traded on the Chicago Board Options Exchange or other exchanges are much different. However, they are similar in that they both represent a call on the future growth and profitability of the company. And so I just wanted to mention that, and certainly many options issued to employees or executives of a company may not be transferable by that employee or executive.

I now have a few questions for Mr. Herz and Mr. Volcker. Mr. Herz, how many of the seven FASB Board members supported the issuance of this proposal? And how many of the seven Board members disagreed with the conclusions contained in the proposal?

Mr. HERZ. The proposal was voted out as a proposal unanimously by all seven Board members.

Senator FITZGERALD. So there was not a single member of your expert Accounting Board who opposed the issuance of the proposal?

Mr. HERZ. That is correct. It was unanimous. Now, we all may have slightly different views on particular issues, minor differences. But you look at the proposal as a whole, its consistency, and decide whether or not to vote for it as a whole. And all seven Board members voted for that.

Senator FITZGERALD. And how are the FASB Board members chosen? Who chooses them? And how do you get on that Board?

Mr. HERZ. They are selected by a group of trustees of the Financial Accounting Foundation. They are selected from diverse backgrounds. Right now we have three people from public accounting, two from industry, one was a senior global equity analyst, another person with a business background.

Senator FITZGERALD. So you have two from industry.

Mr. HERZ. Yes.

Senator FITZGERALD. Who aren't necessarily accountants? Or are they?

Mr. HERZ. They were CFO types.

Senator FITZGERALD. OK.

Mr. HERZ. What we call preparers.

Senator FITZGERALD. OK. So they are from companies that may be issuing options themselves.

Mr. HERZ. Yes. In fact, actually two of our Board members have been the recipients of options.

Senator FITZGERALD. And, nonetheless, they supported the expensing of stock options.

Mr. HERZ. Oh, yes.

Senator FITZGERALD. So of the seven Board members, you have two who are from public companies. How many of the Board members are CPAs, accounting professionals?

Mr. HERZ. Three.

Senator FITZGERALD. Three. And then you have two other members?

Mr. HERZ. A business school professor, and a person from Wall Street who was a senior global equity analyst.

Senator FITZGERALD. OK. So, it is fair to say that all of these people have great expertise. If you are a CPA, a CFO of a publicly traded company, a business school professor, or a respected Wall Street analyst, you are very sophisticated in this area.

Mr. HERZ. I think it is interesting to note that the International Board, who separately deliberated this whole issue, they have 14 people on their Board from nine different countries, and, again, a range of backgrounds in terms of preparers, auditors, users of financial information. I believe they were also 14–0.

Senator FITZGERALD. Maybe Mr. Volcker could comment on the composition of the International Accounting Standards Board. You have 14 people?

Mr. VOLCKER. Fourteen people, two of whom are part-time. But as I look at them here, I think there are four who are basically so-called preparers, chief financial officers; and four or five accountants or standard setters from other countries, past standard setters from other countries; and three of them are so-called users, analysts, with an analyst background. One professor.

Senator FITZGERALD. Now both of you just generally, leaving aside the merits of the proposed rule—and you saw I am in favor of the proposed rule. Some of my other colleagues are also in favor of it; others are opposed to it.

Leaving aside the merits of the proposal, what effect do you think it would have on our domestic Financial Accounting Standards Board if politicians were to step in, a political authority were to step in, and block the new FASB rule? And I think Mr. Volcker indicated in his opening remarks the likely effects on the international board if they were to see us in Congress step in. For a rule that actually isn't that controversial in Europe, it would have ramifications to the extent that some European companies which are opposed to a new rule on derivatives accounting that has already been widely accepted in the United States would possibly object to.

But what would be the effect of political interference in either of your boards?

Mr. HERZ. Well, I think, as I said, there are a number of issues coming down the pike, major topics, where users of financial information believe that the current accounting standards are not as good as they might be, and even in some cases really need major revision. And some of those are areas like revenue recognition and reporting on financial performance, but also pension accounting has been severely criticized by a number of people, lease accounting.

I think that any intervention at this point would kind of be a signal down the road that anytime you want to block something to maintain the status quo and block the proposed standard, go to Washington and lobby through the political process.

Senator FITZGERALD. Would you care to comment on that, Mr. Volcker?

Mr. VOLCKER. Well, I think if I was a member of FASB, I would be wondering what my responsibilities were. I know that in choosing the International Board and getting the kind of quality of people that we thought we got, what was important to them was that they had some independence. And if they lost that sense of independence and acceptability of their decisions, they would not be interested in serving. And I don't know who you would get to go on the Board. You are not going to get the kind of people that we got. I think that is simply the fact of the matter.

But I must say, I think there is a balance here which, one way or another, much of what has been said both on that side of the table and here is relevant. These decisions cannot be made in a vacuum. They cannot be made by a group of abstract accountants kind of figuring out what they think of the theoretical niceties of an accounting rule and ending up with 260 pages sometimes. They have to be exposed to the real world. And in a sense, I think that is my job and our counterpart's job in the United States to make sure that the Boards do have the kind of consultation that Mr.

Herz was talking about and take it seriously and do testing and checking of their proposals.

I should not be speaking as an old Federal Reserve Chairman—but it is easy to get isolated. We have to keep—in a way that is impossible to avoid for the Federal Reserve because you haul them up all the time—and you have these kinds of debates and criticism and comments. And I think that is an important part of the process.

We happen to be reviewing the so-called constitution of the International Commitment now, and that is the main comment we have had, and that is the main concern that we have in reviewing the constitution, that there be ample and suitable consultation and testing.

Senator FITZGERALD. Yes, Mr. Herz?

Mr. HERZ. I couldn't help pass that by when Paul mentioned the 260 pages and Senator Enzi the 230 pages. The actual proposed standard is eight or nine pages. The rest of the document is explaining our thoughts, rationale, alternatives we looked at and then lots and lots of different examples to help people. So, the whole thing of helpful guidance and explanation of our thought process is 230 pages, but the actual standard is very short.

Senator FITZGERALD. It is eight pages, OK.

Now, just one final question before I hand it over to my colleagues. Both Senator Boxer and Senator Enzi talked a lot about the effect on companies, small businesses. They raised the specter of employees being denied stock options. And I know Senator Lieberman talked about the democratization of company ownership via widespread distribution of stock options.

But neither Senator Boxer nor Senator Enzi, at least the way I understood them, seemed to mention the effect on shareholders or investors. That is something I referred to in my opening statement, that by granting stock options, you are taking the existing common shareholder's right to own 100 percent of the up side of a company, and you are transferring it to someone else. And that is OK, I said, as long as it is disclosed to the shareholders or prospective investors, that they know that somebody else has a claim on these future growth prospects of the company and the stock.

But isn't there a problem with so many Americans owning stocks today? Just in mutual funds alone you have 95 million Americans who own mutual funds, for example. Either directly or indirectly today, well over half of Americans own equity securities. And many people are investing on their own without any professional advice and, I would venture to say, many without the ability to recognize the dilutive effect of options that have been issued because they are so buried.

Was that at all a part of the thinking of the Financial Accounting Standards Board? Were you worried about that effect on shareholders of the dilution?

Mr. HERZ. Well, we are trying to measure the instrument that is granted as a cost to the company, and it is a cost to the company, and that cost is represented by exactly what you say. And it is measurable. It is measurable with well-established models. It takes a little bit of work to do it in some cases, particularly when they are more complicated. But that is exactly the point, that there is a cost to the company, and that cost to the company should be measured just like any other cost to the company.

Senator FITZGERALD. And if employees are paid in cash or in gold bullion, you require them to expense that. But it didn't seem logical if they are paid in stock options, because they don't have to reflect the cost?

Mr. HERZ. Yes, that is right. And just to get to—I would love to visit with Senators Bennett and Lieberman just to explain——

Senator FITZGERALD. We would be happy to give you that opportunity.

Mr. HERZ [continuing]. How the measurement works and why they have been able to do it for 8 years, in audited footnotes, why many companies are now being able to do it, and why there are other very long dated type instruments like convertible bonds which may be contingently exerciseable. Those are valued every day.

The other point I would make, which is, I think, a point that when we discuss this people say well, gee, it didn't turn out to be the right value. Well, we are measuring the value at a point in time. We are not predicting the future value of that instrument. Just as if you award a share of stock today, that is not predicting what it will be worth 5 years from now. It is the value of the instrument now. That is what is being valued, not the future prediction of its value.

Senator FITZGERALD. And there is a present claim or call on the future growth of the company's prospects that is being——

Mr. HERZ. That is exactly what the model is.

Mr. VOLCKER. And it does take account of the vesting.

Mr. HERZ. The vesting also, if you don't vest, there is no expense. There are adjustments in our proposal for vesting, for non-transferability, for restrictions and all the like.

Senator FITZGERALD. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Chairman Volcker, there are some opponents of the FASB proposal who argue that expensing stock options would slow job creation and potentially increase the use of outsourcing. What is your evaluation of these arguments?

Mr. VOLCKER. They are not correct.

Senator AKAKA. Thank you.

Mr. Herz, accounting rules have long required companies to estimate and report as an expense the cost for remediating environmental contamination, providing pension and post-retirement benefits to employees, settling product liability claims and litigation, and providing warranty coverage on products sold to consumers. The question is: Will the proposed measurement approach for employee stock options result in a more precise measurement than approaches currently used for those other costs and can you give me the reasons why?

Mr. HERZ. Well, you are touching on a key aspect of what we considered: Is there sufficient reliability in our view behind these measures? And by that, we mean that the range of dispersion of the likely outcomes, if it is done correctly, is within acceptable limits. And we then thought about that and compared it with some of these other measurements that you are talking about and some that I think Chairman Fitzgerald talked about, loan loss reserves, insurance reserves, impairments of good will, sometimes just depreciation calculations because they involve estimates of life and salvage value. And we think that certainly the established models here—and, by the way, people say that you didn't choose a model. Well, they are just different parts, variations of the same financial economic theorem. They are not different models. One is more flexible or open than the other. You can put more inputs in it and get a more refined answer. But our basic conclusion is that these measures are of sufficient reliability to put in the financial statements and are far better than the current situation where the current accounting is totally unreliable and completely ignores an economic transaction.

Senator AKAKA. Mr. Volcker, what lessons regarding the use and accounting for stock options should be learned from the failures in corporate governance by companies such as Enron and WorldCom?

Mr. VOLCKER. Well, my view is—and it has already been expressed in this hearing earlier—that I really do think stock options have been abused, and too much concentrated on relatively few officials at the top, and the incentives that have been created have been perverse. It has created a kind of concentration on the stock price that has led to manipulation of earnings and other manipulation in order to affect the stock price at the long-run expense of the company itself. And we have seen that demonstrated. It is very hard for me to justify the use of an instrument that has rewarded, as someone said earlier, tens of millions of dollars, even hundreds of millions of dollars, to executives of a company that went bankrupt that very year. It just does not make sense.

What is evident and why people like stock options so much is that we have just in the 1990's had the greatest boom in the stock market in all of history. And if you had a stock option, you did very well. You did very well whether your company was doing relatively well or whether it was doing relatively poorly. Everything was going up, not because you were suddenly a great genius, but because the whole market was going up.

I think we better think about it here. I don't make up the rules, but I think the effort is to put compensation in the form of stock options on a level playing field with other forms of compensation so that you do not distort the instrument that is used simply because it is accounted for differently, and accounted for in a way that logically is hardly sustainable.

Senator AKAKA. Mr. Herz, this month the Congressional Budget Office released a report which found that net income will be overstated if firms do not recognize as an expense the fair value of employee stock options measured when options are granted. What is your evaluation of CBO's conclusion?

Mr. HERZ. Their conclusion is exactly the same as our conclusion. It is the same as the IASB's conclusion. It is the same as the conclusion that has been reached after study by many different groups over a long period of time.

Senator AKAKA. Mr. Volcker, if Congress intervenes to block the FASB proposal, what impact will this have on investor confidence, on the financial markets, and the ability of analysts to evaluate the financial condition of public companies?

Mr. VOLCKER. Well, I think the influence would be adverse in all those terms. I don't know how striking it would be. They have not been accounted for in the past so you are not changing the situation.

What I am certain of, it would clearly undercut the efforts to get international consistency. And I think over time that is to the disadvantage of both companies raising money and investors investing money.

You want both intelligent, comprehensive accounting standards, and you want them the same in different jurisdictions when both investors and companies are operating in a lot of jurisdictions. It is very difficult for our biggest companies—forget about the small companies—our biggest companies that may be operating in 60, 70, 80, or 100 countries to follow 100 different accounting rules. And the effort is to reduce those differences as much as possible.

Senator AKAKA. Mr. Herz, can you please describe for the Subcommittee the shortcomings of disclosing stock options in footnotes of financial statements compared to FASB's proposal?

Mr. HERZ. I think it is a longstanding principle in accounting and financial reporting that disclosure is not meant to be a substitute for wrong accounting. And that has been borne out by numerous academic studies in general and on this topic as well.

I think the CBO report comments that individual investors do not comb the footnotes, and they just take the score as is. That is the score as reported, and that is the way they look at it.

I think in talking with a number of institutional investors and quantitative analysts, they also do that because they take numbers from databases and don't take as adjusted footnote numbers. They just take the score. And so that is why we have gotten so many—all the surveys you see of investors, analysts, portfolio managers by an overwhelming margin say they want this number in the score.

Senator AKAKA. Thank you very much for your responses. Thank you, Mr. Chairman.

Senator FITZGERALD. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Let me say what I said in my opening statement again so that it is clear. I am in favor of expensing stock options. I am in favor of maintaining FASB's independence. The points that Paul Volcker is making are absolutely on point. We need to do what we can to standardize around the world. So let's not revisit that, OK? Let's deal with what I think the real problems are, which I think FASB has ignored.

Let me give you a hard, firm example here. You say it is eight or nine pages, it is fairly simple. I am delighted. I have a stock option which, according to Black-Scholes, is worth $10. It can be exercised tomorrow. I give my employees a stock option with a 10-year vesting at the same strike price as the stock option that I get. What is that worth? What does the 10-year vesting do? What is it worth? Look at your nine pages and give me a number.

Mr. HERZ. OK. The first stock option would be expensed all right now, $10. The $10 on the second one would be spread over 10 years, but if the fellow left, there would not only be no more compensation, there would be no compensation.

Senator BENNETT. OK. So it is still worth $10, even though it can't be——

Mr. HERZ. Not from an accounting point of view.

Senator BENNETT. You just said that it would be——

Mr. HERZ. There is a measurement——

Senator BENNETT. You just said the $10 would be stretched over the 10 years.

Mr. HERZ. The measurement would be 10. It would be stretched over the 10 years, but only to the extent the person worked to get it. That was the deal.

Senator BENNETT. No. I am talking about putting it on my balance sheet as an accountant, putting it on my P&L. I have got one P&L; I deduct $10. That is very simple. Do I deduct $1 this year and $1 next year, etc., for the other one?

Mr. HERZ. As long as the guy kept working to get it, yes.

Senator BENNETT. So he drops dead of a heart attack in year 9, and my balance sheet shows a cumulative expense of $9.

Mr. HERZ. The balance——

Senator BENNETT. In fact, do I get that $9 back?

Mr. HERZ. Yes.

Senator BENNETT. So that becomes profit.

Mr. HERZ. It is not on the balance sheet, by the way.

Senator BENNETT. Well, the P&L goes to the balance sheet. What happens to that $9? Does it become profit? Does it run to the balance sheet?

Mr. HERZ. Yes, it runs back through the income statement and back through equity that was never created.

Senator BENNETT. So in year 9, magically I have got $9 worth of income. Do I pay taxes on that?

Mr. HERZ. Do you pay taxes on $9?

Senator BENNETT. On that $9 that suddenly comes back in 9 years.

Mr. HERZ. The awardee of these stock options?

Senator BENNETT. The company. Forget the company. I have got to keep the books.

Mr. HERZ. No, the company does not pay any taxes. It is not——

Senator BENNETT. I get $9 worth of income and I do not pay any taxes on it? That is going to get Senator Levin really upset.

Mr. HERZ. That is accounting income.

Senator LEVIN. I would like to hear his answer to that.

Senator BENNETT. Well, I would kind of like to hear the answer, too.

Mr. HERZ. Well, first of all, you would have estimated for the whole group on day one how many people were going to be there through the 10 years. So you would have made an estimate of what is called forfeitures.

Senator BENNETT. Right.

Mr. HERZ. But in that situation, you would take back the $9. The deal was never completed. You had estimated wrongly.

Senator BENNETT. But I got income on my income statement.

Mr. HERZ. That is correct.

Senator BENNETT. And I do not pay taxes on that income.

Mr. VOLCKER. That would depend upon the IRS.

Mr. HERZ. Well, it would depend on—not in the United States you wouldn't, because the tax deduction, the stock option tax deduction actually occurs for the excess, the windfall of the value given.

Senator BENNETT. All right. Let's go back to the first one. The first one, no problem, Black-Scholes says it is $10. I put $10 as expense. Do I get a $10 tax deduction?

Mr. HERZ. Yes.

Senator BENNETT. So if I am a small businessman——

Mr. HERZ. You get the $10 tax deduction or a higher tax deduction when the person actually exercises the option.

Senator BENNETT. Well, wait a minute. I am drawing up my tax return for this year, and I have got $10 worth of expense.

Mr. HERZ. You have $10 of accounting expense.

Senator BENNETT. Right. Can I take a tax deduction to that?

Mr. HERZ. Not on your tax return. What you have is a deferred tax benefit for accounting purposes.

Senator BENNETT. OK. When do I get to take the tax deduction?

Mr. HERZ. As Senator Levin said, when there is an exercise of the option by the employee. Let's say when the employee exercises and that employee—let's say the stock has gone to $100, and he makes a profit of $50, say, because the strike price was, say, $50. The employee would declare taxable income of $50, and the company would get a tax deduction of $50 for taxable compensation.

Senator BENNETT. So I take the expense in year 1, but I do not get the tax deduction until, say, year 5.

Mr. HERZ. Right.

Senator BENNETT. And you say that is making the financial statements clearer and more accurate if I don't get the tax deduction in the same year that I take the expenses?

Mr. HERZ. Well, the Tax Code and accounting are not the same. They are not designed to be the same.

Senator BENNETT. Bingo.

Mr. HERZ. Right.

Senator BENNETT. That is the point that so many people are missing in this debate. The Tax Code and the accounting for expenses are different. So you are going to say to me as a company, you have to show in your statement to a shareholder that you just made no profit. Let us say the total cost of the options matches total amount I make, so you just show you have made no profit.

Mr. HERZ. Correct.

Senator BENNETT. In the footnote you have to say you have really got a lot of cash.

Mr. HERZ. We have a cash flow statement. There are four basic financial statements.

Senator BENNETT. Yes, you have got a cash flow statement. As a manager running a business, when I was running a small business, I looked for every deduction I could possibly find. Why? Because I didn't want to pay any taxes. I managed the business to make sure that we didn't earn a dime.

Now, this is not a public company. This is a private company. I have run public companies and private companies. And I will tell you, private companies are a whole lot more fun. But we didn't want to earn any money, accounting-wise, because we needed every penny of cash to make that fledgling business survive. So I looked for every possible deduction.

So you come along and say, Here, you can deduct the cost of your stock options, and I say, Wonderful, do as many as you can so I can build as many deductions so I can save cash. The IRS says, no, we don't recognize those as real expenses.

Mr. HERZ. That is right.

Senator BENNETT. Now, as soon as I go public, yes, FASB says they are real expenses, but IRS does not. I have to charge them against my income statement, and, therefore, they end up on the balance sheet as a lower reduction in retained earnings. But I do not get any tax benefit for doing that—except in certain countries, apparently, as we begin to go international.

Mr. HERZ. In certain countries, they have an economic valuation like we do for accounting, rather than an outcome approach.

Senator BENNETT. OK. The point of all this—and I will quit belaboring it. I am late to another meeting, and I apologize for just dumping this on you and having to leave. I want the financial statement to be as clear as possible, and so do you. That is why I favor expensing. But I am convinced that the way you have drawn this up is going to make the financial statement absolutely incomprehensible to somebody that does not have the kind of experience and background you do. And I guarantee you that Senator Enzi's concern about small business is not ill-placed.

Mr. HERZ. Well, for Senator Enzi and small business, we have proposed an alternative method, which is like the tax method.

Senator BENNETT. So as soon as you get above a certain level, the rules change.

Mr. HERZ. No. It is because for a private company you do not have liquid stock. There is a cost/benefit issue, and we think that makes—it is not pure, but it is a decent alternative, just like what you are saying.

Senator BENNETT. How can you be sure that we do not have liquid stock if we do not have a public market? My brother-in-law might want my stock.

Mr. HERZ. Well, then we are going to let you—the alternative then would be to do the right method and value it economically.

Mr. VOLCKER. Brothers-in-law are not usually very liquid. [Laughter.]

Senator BENNETT. Each of us is a prisoner of his own experience. And my experience running little companies, handling start-up companies, one or two of which actually became big companies and ended up listed on the New York Stock Exchange—and they were a lot more fun to run, again, when they were private before we had to deal with analysts. It tells me that—sorry to disagree with my tall friend—there are some consequences that will affect the economy if this thing does not become a whole lot more user-friendly to the brand-new kind of stock option that has just grown up in the relatively recent future where you say we are going to have long-term vesting and we are going to have wide participation and it is going to be in start-ups. And that has helped fuel the growth of the American economy, and I do not think you have paid enough attention to that.

At the end of the day, I am still with you that we ought to expense. I am still with you that we ought not to pass legislation. But I am very troubled that the consequences of what you have done seem to be so skewed towards the public company, the General Motors, the Coca-Colas, and the Microsofts of this world, that you could do significant harm in the entrepreneurial area. And that is what Senator Boxer is saying.

As I say, I have not signed on to the Enzi bill. I have been under a lot of pressure to do it. I look at the Enzi bill, and I see a lot of things wrong with it. But I hope I have gotten across to you that even though technically I am in your camp, I am very troubled at the results that I see in the work that you have done.

Mr. HERZ. Well, if I could respond?

Senator BENNETT. Sure.

Mr. HERZ. First, as I said, we have still a lot of due process left. We are meeting with the Small Business Advisory Committee. We have specifically crafted questions about not only private companies but small business issuers as to what ought to be appropriate there.

As I said, we have proposed an alternative method, which is closer to what you are proposing, which would not require option pricing models, which would be more on what you seem to favor in general, what is called an exercise date type approach, which is kind of the accounting version of the Tax Code. And those are all things that we have invited comment on. So, rest assured we will be looking at all that, and we are very sensitive to the cost/benefit burdens, to the understandability. We have a question specifically in the notice to recipients about understandability. That is why we have lots of examples, as I said, in the document.

So, I hope you will also have an open mind, and maybe we can visit with you.

Senator BENNETT. I would be delighted to. Thank you, Mr. Chairman.

Senator FITZGERALD. Thanks, Senator Bennett. Senator Levin.

Senator LEVIN. It seems to me there are two key issues: One is the difficulty, allegedly, of valuing something at a date which it is given to the employee, because you have got to estimate its value and it is not exercisable until some future date. And I would like to get some more examples from you as to how they work and about other forms of compensation which are also based on uncertainties where we do value. You have used two terms that I do not think—at least I am not familiar with one of them. Long-dated stock warrant, I think was the term. Another one was a convertible bond. And I think if you could just give us a word or two on each of those, it might be useful to show this is not some unusual, novel feature here, that we apparently do value things which are difficult to value.

Now, we talked about good will and a number of other things which we are familiar with, even depreciation. But just in terms of these kinds of—I think you called them equities. What is a long-date stock warrant? And how is that similar to——

Mr. HERZ. Well, companies will use stock purchase warrants, which are like a stock option. It gives the counterparty, the holder, the person that you grant it to, the ability, the right to buy your stock, a share of your stock at a fixed price for a fixed term. And it may have various conditions in it. For example, it may be to a provider of services to your company that says you can do this as long as, if you are a lawyer, we win the next following five cases. Or if we only win four cases, then the terms of the warrant will change a little bit. I mean, these can get quite complicated, but——

Senator LEVIN. Are they valued now?

Mr. HERZ. Yes, they have been required to be valued for many years and accounted for.

Senator LEVIN. At the time that they are granted?

Mr. HERZ. Yes.

Senator LEVIN. All right. So there are models, there are ways of valuing those kinds of conditional grants or transfers of stock.

Mr. HERZ. Right.

Senator LEVIN. What about the convertible bond?

Mr. HERZ. Well, a convertible bond is a bond that contains a stock option in it. It basically allows at a fixed price the person to convert the bond into a certain number, a pre-specified number of shares. And those terms can go out 10, 15, 20, or 30 years. There has been in vogue recently what are called contingently convertibles, which not only have that feature but you can only actually do the conversion based upon some kind of formula of the stock price in the future meeting certain target levels. It only gets contingently triggered, yet you have to——

Senator LEVIN. Those contingent triggers are, nonetheless, valued in some way.

Mr. HERZ. Sure. The instruments are valued every day in the marketplace.

Senator LEVIN. But these can't be valued in the marketplace, I gather—or can they?

Mr. HERZ. Yes, they can. The convertible bonds are traded——

Senator LEVIN. No, I am talking about the stock option given to an employee. Can they be valued in the marketplace since they cannot be exercised by anyone other than that employee?

Mr. HERZ. No, they do not trade in the marketplace, although as the CBO report comments, individuals, if you have enough of them, you can find ways to extract the value, protect the value through hedging devices.

Senator LEVIN. So through a hedging device you actually can extract, as you put it——

Mr. HERZ. You can monetize the value at a point in time.

Senator LEVIN. Even though it cannot be exercised by anyone other than the employee?

Mr. HERZ. Right.

Senator LEVIN. OK.

Senator FITZGERALD. They are not transferable, is that why they cannot be sold?

Mr. HERZ. That is correct. And as part of our methodology, we recognized that, and, in fact, there is a big hair cut effectively for that in the modeling.

Senator LEVIN. All right. Now, that is extremely helpful information, I believe, because one of the issues we hear a lot from people who want to override FASB is you cannot value these. And you are saying there are all kinds of contingent instruments, conditional instruments, which are valued all the time that are similar to these instruments.

Mr. HERZ. And often more complicated.

Senator LEVIN. And even more complicated.

Now, the other issue has to do with, I think, your conversation with Senator Bennett, if I followed it, and that had to do with there may be an option open to small businesses where you are going to allow them—particularly if they are not publicly owned, I gather—to opt into the certainty of saying, OK, you do not want to do that when they are exercised, if they are exercised, if you take a tax deduction at that point they show up on your books. Did I hear you correctly?

Mr. HERZ. Yes, well, what we are doing is saying take, as you go along, what the difference between the current value of the stock and the strike price is, and then finally at exercise date, you would have the final measurement there. So it is kind of each period you would be showing what the status is.

Senator LEVIN. Would it be the same as a tax deduction?

Mr. HERZ. The final measurement overall would be the same as a tax deduction for non-qualified stock options.

Senator LEVIN. All right.

Mr. VOLCKER. Then you know what the value of the stock is, and there is no——

Senator LEVIN. Excuse me, Mr. Volcker. What were you saying? Repeat that so we can all hear it.

Mr. VOLCKER. I don't know how you keep adjusting the value of the option when there is no market for the stock.

Mr. HERZ. You would value the stock just like you do for tax purposes in order to figure out the tax deduction.

Senator LEVIN. But at the end of the day——

Mr. VOLCKER. You don't have a market.

Senator LEVIN. Wait a minute, if you are going to speak, which is fine, I think we have got to get this on the record so we understand what you two guys are saying. This is an unusual hearing in this regard, but it is welcome, provided we can—I would welcome it on my time, providing I understand what you are saying to each other.

Now, at the end of the day, however, the amount of the tax deduction would equal the amount of the expense shown on the books under that option. Is that correct?

Mr. HERZ. The cumulative expense, yes.

Senator LEVIN. OK, but that is the bottom line at the end of the day.

Mr. HERZ. That is right.

Senator LEVIN. Putting aside the difficulty that Mr. Volcker is talking——

Mr. HERZ. By the way, we have also said that if you are a public company and you really don't think you can do the grant date valuation with sufficient reliability, and you convince your auditors of that, and possibly you might get chosen for SEC review and you would have to convince them. But you could use that alternative method in that circumstance as well.

Senator LEVIN. That is the certainty approach. Have you gotten much support from the business community for that approach?

Mr. HERZ. No, and I think for two reasons. One is—I think they believe that the value—the cost is the grant date because that is the date the deal is made and it is based on today's price and you kind of figure out what the value is then.

Senator LEVIN. So the business community wants the grant date to be the date that the valuation takes place, and yet it is the same community that says you cannot value on that date.

Mr. HERZ. Well, I think certain elements of the business community.

Senator LEVIN. Well, it is part of the business. But part of the argument you get from the opponents is you cannot value on the date that you give the right away. But part of the opposition we also hear is you cannot value on that date. It seems to me that those are two inconsistent arguments. At least the same person should not make both arguments.

Mr. HERZ. I agree.

Senator LEVIN. Now, do you know how many companies now expense stock options? There are quite a few that are actually now doing it.

Mr. HERZ. The last tally I saw that either already are or said they will be in the near future was about 500.

Senator LEVIN. And those would be fairly significant size companies?

Mr. HERZ. Yes. I mean, there are, as I remember, about 115 of them are in the S&P 500 and——

Senator LEVIN. And have they shown any loss in stock price as a result, do you know? Have you seen any studies on that?

Mr. HERZ. I saw a study by Towers Perrin recently that said they didn't.

Senator LEVIN. Did not?

Mr. HERZ. They did not suffer a loss in stock price. I also saw another study by some professors—I think one was at Stanford as I remember—that said they actually got a very short-term bounce, probably on the view that they got some reward for better accounting, better corporate governance.

Senator LEVIN. Thank you. My time is up.

Senator FITZGERALD. Thank you. Senator Lieberman.

Senator LIEBERMAN. Thank you, Mr. Chairman. This has been a really interesting and important hearing. I wanted to share an observation and then ask a few questions, and it is about this question of the independence of FASB, which I respect.

We are not accountants up here. Senator Enzi happens to be the only accountant in the Senate, as far as I know. So why did I get interested a decade ago? Because I was concerned hearing from people in business about the impact of the accounting change that FASB was proposing on the economy, on millions of workers who are benefiting from options, etc.

If I understand the history here, you are essentially a private group—really, a professional group, exercising an authority that has significant public effects. And if I get it correctly, this is a public authority that was granted by statute to the SEC to set accounting standards, which it in its wisdom delegated to FASB.

So you have got a situation where a public authority has, for reasons that make a lot of sense in most cases—because we should not be doing accounting standards. That is not our business. But you have got a public authority granting this power to a private entity, and then it makes a judgment that has, at least in my opinion, and obviously a lot of others, in this case a big effect on public policy, on the economy. And yet part of my concern is that with independence in this case comes no accountability. So your decisions cannot be appealed to court, can they?

Mr. HERZ. I am not sure about that, but——

Senator LIEBERMAN. Can I ask one more question and then let you respond? Just as a factual basis, can the SEC—I assume—let me state it as my on-one-leg opinion—that the SEC retains the authority to override a FASB ruling. Is that correct?

Mr. HERZ. Yes, that is exactly correct, and we are subject at the technical level to very detailed oversight, monitoring, and involvement by the SEC staff. They have been following every aspect of what we do on this project and every other project. They can and have on occasion said, gee, we don't agree with what you are coming up with, either stop or we will override it. That has happened on one occasion in the past, on another occasion back in the 1960's with the investment tax credit Congress overrode the then Accounting Principles Board.

You raise a good point, and it is, to a certain extent, a difference in philosophies or public goods. The view of accounting standard setting, whether it be our Board or the International Board, is that we really have to be unbiased and neutral as to the economic consequences. The economic consequences do flow from better information. What you measure matters and the like, and that is the best way to assist the capital markets and the credibility of overall financial information.

Now, there are other people who would assert another public policy good, but that is not, in fact, in the SEC document that re-recognized us after Sarbanes-Oxley, it basically said, reaffirmed that what we do has to be objective and neutral.

Senator LIEBERMAN. Right. So that gives me some comfort, if you will, and I would welcome your responding in writing afterward about my assumption that FASB's rulings are not subject to appeal in court. But the way to balance what FASB's independence brings and the possibility whether in this decision or another one—let's assume that this decision is a debatable one. Arguably, FASB might do something that most of us up here and in America would think was lunacy, whatever it is.

The accountability and the public interest in that then goes to the SEC, which has the authority to override, and obviously that is something that they can consider as this particular proceeding goes on.

Listening to Senator Bennett, he said he is for the expensing of stock options, but I think his questioning really brought out why those of us who have said we are not for the expensing of options at the time of granting have such a problem with this, because we do not know how you can do it accurately. At one point, I think you said if the value—the point here is to try to put a value on the option now, on the day it is granted. But the only value that I can see that the option has on the day it is granted that I would have any confidence in is the stock price on that day, the market price on that day. But, of course, it is not going to be exercised.

You said earlier that since 1995, when FASB required the footnote disclosing, according to Black-Scholes, the value of the options that people have been doing it and living with it. But is there any basis for—in other words, they have been applying the formula, but is there any basis for having any confidence that it is accurate, that the result of it is accurate?

Mr. HERZ. Well, it is accurate based upon the accuracy of the valuation. Again, these valuations are based upon models that are basic financial economic theorems and that are tested every day in the markets for these other instruments. There are certain adjustments you make for employee stock options because of the transferability aspects, the vesting aspects, and those kinds of things. But the basic models themselves are tried and tested in the marketplace.

Senator LIEBERMAN. Let's say that on the day of granting, the market price is $10 a stock and, according to Black-Scholes, the value of it is $20.

Mr. HERZ. No, it cannot be more than the stock.

Senator LIEBERMAN. I am sorry. It is the—well, OK. I am sorry. I am going to the deductibility.

Here is my point. Let's say that when we get to the date of exercise there is an obvious difference between what Black-Scholes predicted and what the value really was to the employee. Is there any way to alter the expenses if they turn out to be inaccurate so that the company is not—this is, I guess, in a way what Senator Bennett was asking you—is not stuck with the impact of having expensed at a greater, or even a lesser rate, in the interest of equity, than it turned out to be?

Mr. HERZ. Well, we are continuing to talk a little bit past each other, but because, again, the grant date value is the value at the grant date, the model takes into account Black-Scholes, a million different possibilities of where the stock might end, not just——

Senator LIEBERMAN. Yes, but that is my problem. It is only going to end in one place.

Mr. HERZ. That is correct. But I would commend you to read the CBO report as to why the grant date is the right cost to the company.

Senator LIEBERMAN. I will. Let me ask this question: If the Black-Scholes system has been working so well, why in the released exposure draft have you urged companies to use the binomial or lattice model to value employee stock options?

Mr. HERZ. The lattice models are—it is like taking Black-Scholes and opening it up. Black-Scholes is kind of hard-wired. You have to put a set of uniform assumptions into it, and then it cranks out a value. The binomial model allows you to, for example, say, well, I am going to sell division and, therefore, my volatility and dividend policy is going to change next year. It allows you to take the assumptions and change them by periods, just as you would if you were going to, for example, value an intangible or value an in-process R&D project, which are regularly done. It is taking the Black-Scholes and opening it up.

So what it means is that you can, getting the right information, you can get a more refined estimate than just the simple Black-Scholes because it is less flexible.

Senator LIEBERMAN. My time is running out, and I want to let the next panel come on.

Why not avoid all of these problems that we have talked about, about the difficulty of predicting the value of a stock a year or 5 years or 10 years forward, when there are so many variables, by requiring the expensing to occur on the day it is granted, when to me it has no value. The value comes to the employee, as the tax system recognizes, when he exercises it because he pays a tax on the spread between the price of the stock on the day he got the option and the price of the stock that he exercised it—and, incidentally, as has been pointed out, the company gets to deduct the spread.

So in what Senator Levin refers to as a double standard, we disagree on that—the same thing is bothering both of us but we have come to different conclusions. Why not resolve the problem by requiring an expensing of stock options on the date of exercise?

Mr. HERZ. Well, we could do that. We do not think it is the proper measure of the compensation. It is what the individual actually gets out of it, but it is not the measure of the cost to the company.

Again, I would commend you to the CBO report to understand why——

Senator LIEBERMAN. Talk a little bit about that. It is what the individual gets out of it. It is what the company——

Mr. HERZ. As Chairman Fitzgerald said, once you issue this, what happens is there is a wealth transfer that goes on after that between the existing stockholders and these new equity owners.

Senator LIEBERMAN. But it is of indeterminate value.

Mr. HERZ. No, it can be valued——

Senator LIEBERMAN. It dilutes the stock to some extent, but we don't know how much until it gets exercised.

Mr. HERZ. You don't know the final measure of what that is, but you know the value at any point in time.

Now, we could do that, but then the question would be: Would we also do that for every other instrument that takes these same kinds of things, like a convertible? If I issue to you a convertible and 15 years down the road you may convert that, and although you only paid $1,000 for that bond, you may convert it—this was a very successful company—at $30,000. Should we measure the expense to the company at $30,000?

I will give you another example: Stock purchase warrants that are issued to suppliers. I give you 10 of my stock purchase warrants for 10 of your widgets, and we will agree that your widgets are each worth $5 and my warrants are each worth $5, so we have a fair value exchange of $50. Those warrants entitle you to exercise or to buy the stock at a fixed price for 10 years. Nine years down the road, I am, again, a successful company; you exercise it for $300. Should we have said that the cost of the goods that I got from you, the five widgets, was $300, not $50? It is incongruous.

Senator LIEBERMAN. My time is up, but I would really urge you to do everything you can to open up the hearings that you are going to hold and make sure you hear from people on all sides and think about what they say. And then obviously I hope that the SEC will follow what you are doing and exercise the authority that it has delegated to you if it thinks that FASB has done something that is not right. Thank you very much.

Incidentally, this is very difficult for me to go through this debating process with Mr. Herz because he and FASB, I am proud to say, are located in Norwalk, Connecticut.

Senator FITZGERALD. Well, thank you, Senator Lieberman.

I have just a couple of wrap-up questions. Have you had any indication from the SEC as to their views on this new rule? They haven't given any indication that they——

Mr. HERZ. Well, they completely support our process. I think both the chairman and the chief accountant have said they are in favor of expensing. Many of their staff have been involved and actually helped with crafting a lot of suggestions along the way, more in terms of crafting the questions and the like. But they will continue to——

Senator FITZGERALD. So we have the SEC, Alan Greenspan, his predecessor Paul Volcker, Warren Buffett, and others, all supporting the concept of expensing stock options.

On the Tax Code and accounting, isn't it true that what companies tell the IRS is that their earnings are far less than what they report to the public? In fact, companies now report to their shareholders many times the earnings than what their earnings are that they report to the IRS. We used to have pretty good parity between what you reported to the IRS as your earnings, probably until the early 1960's or so. As an investor I would like to see the tax returns that a company I might invest in submitted to the IRS, because I tend to believe their real earnings are closer to what they report to the IRS than what they report to the public.

Mr. Volcker.

Mr. VOLCKER. I think there is no question that there is a discrepancy. It seems to be increasing, and something ought to be done about it. But if the accounting is correct, presumably something ought to be done about it from the tax side.

Senator FITZGERALD. That is right.

Now, I just wanted to clarify one point. Senator Boxer said that it was not appropriate for lobbyists to be testifying. I did not invite lobbyists to testify. I invited the CEOs of Cisco, Intel, Hewlett-Packard to testify or send a high-ranking corporate official, CFO or other officer. None of them wanted to do that. We tried other companies, as well. Nobody who was refusing to expense stock options wanted to come and trumpet that to America in a public hearing. I thought that was very telling because I thought they weren't necessarily really wanting—they were not really proud of what they were doing. They are a little bit sheepish about it.

And, with that, I want——

Senator LEVIN. Could I just ask Mr. Volcker if he might be willing to expand for the record, perhaps, his one-word answer, "No," when he was asked by Senator Akaka whether or not he thought this rule would increase the amount of outsourcing or slow job creation? I know that we have taken a lot of time now, but if he would be willing for the record just to expand on that answer.

Mr. VOLCKER. Well, all I mean to say is that nobody is prohibiting stock options, if that is considered a uniquely advantageous way of rewarding people, and it may be for some start-up companies. But I don't think the way they are going to account for it should dominate that consideration, and that if it is really the right way to compensate, go ahead and do it. If you don't compensate that way, do it some other way. But it will appear as an expense.

Senator LEVIN. Thank you, Mr. Chairman.

Senator FITZGERALD. And somebody mentioned China, too. Isn't it true that China will require the expensing of stock options?

Mr. VOLCKER. I believe so. [Laughter.]

Senator FITZGERALD. OK.

Mr. VOLCKER. China will follow international accounting standards, which apparently will—I mean the present international accounting standard requires.

Senator FITZGERALD. Well, thank you, gentlemen. We are delighted that you were here today, and your testimony was interesting. Senator Bennett is also on the Banking Committee, and he declined an opportunity to question Alan Greenspan at his hearing to be here to talk to both of you. So thank you both very much for being here.

Senator FITZGERALD. At this point I would like to invite our third and final panel up to the witness table. I have to warn everybody that I have to leave at 5:30 p.m. If Senator Levin is still here, I would be happy to allow him to take over, but this is going to necessitate that we move pretty rapidly through our final panel.

Our first witness is Jack T. Ciesielski, the owner of R.G. Associates, Inc., an investment research and portfolio management firm located in Baltimore, Maryland. Mr. Ciesielski is the publisher of "The Analyst's Accounting Observer," an accounting advisory service for securities analysts. Before founding R.G. Associates in 1992, he spent nearly 7 years as a security analyst with the Legg Mason Value Trust. From 1997 to 2000, Mr. Ciesielski served as a member of the Financial Accounting Standards Advisory Council, which advises the FASB, and he currently serves on the FASB's Emerging Issues Task Force.

Our second witness on the panel is Damon Silvers, who is an Associate General Counsel for the AFL–CIO. Mr. Silvers' work at the AFL–CIO includes corporate governance, pension, and other business law issues. He is a member of a number of boards and advisory groups, including the Public Company Accounting Oversight Standing Advisory Group, the Financial Accounting Standards Board User Advisory Council, and the New York Stock Exchange Stock Options Voting Task Force. Prior to his work at the AFL–CIO, Mr. Silvers was the Assistant Director of the Office of Corporate and Financial Affairs for the Amalgamated Clothing and Textile Workers Union.

Our third witness is from my home State, Donald P. Delves, who is the President and Founder of The Delves Group, which works to foster the growth and development of businesses through evaluating and building effective total compensation systems. Mr. Delves, as I said, is from Illinois and he has over 20 years of consulting experience in the area of compensation and incentive systems. He is a popular speaker on executive compensation, stock options, and corporate accountability. He recently sent me a copy of his new book, "Stock Options and the New Rules of Corporate Accountability: Measuring, Managing," which was published just last year, in October 2003. Mr. Delves, thank you for being here.

Our fourth witness is Mark Heesen, who is President of the National Venture Capital Association, NVCA. The NVCA is a member-based trade association that works to maintain high professional industry standards and foster an understanding of the importance of venture capital in the United States and global economies. Since 1991, Mr. Heesen has worked on behalf of the venture capital community to enact a wide range of policies that benefit the venture capital and entrepreneurial communities, including the significant capital gains differential securities litigation reform, accounting treatment of stock options, and reform of the Food and Drug Administration's pre-market approval process.

Our final witness is someone whose columns I love reading in the Sunday *Washington Post.* They are normally very insightful and very good, and the column was very good this past week. It is James K. Glassman, who is a resident fellow at the American Enterprise Institute for Public Policy Research, AEI. Mr. Glassman's research addresses such areas as Social Security, economics, the Federal budget, interest rates, the stock market, and taxes. During the past 10 years, Mr. Glassman has written a weekly syndicated column for the *Washington Post* on investing. He is the author of "The Secret Code of the Superior Investor." He has written two books geared toward small investors and has published numerous articles on investing topics in publications such as the *Reader's Digest* and the *Wall Street Journal.*

Again, I would like to thank you all for being here. As I said, we are going to have to end at 5:30 sharp. I am, therefore, asking you to please submit your lengthier written statements for the record. But please try and summarize your remarks in 5 minutes or less so we can finish on time. In fact, that won't leave us much time even for questions, so the quicker, briefer, and more succinct you can be in your opening statements, we would really appreciate it.

Mr. Ciesielski, will you begin. Thank you.

TESTIMONY OF JACK T. CIESIELSKI,[1] PRESIDENT, R.G. ASSOCIATES, INC.

Mr. CIESIELSKI. Thank you. Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee, I am Jack Ciesielski, President of R.G. Associates. It is my pleasure to be participating in this hearing, and I look forward to answering your questions if we have time.

I have a brief prepared statement, and I would respectfully request that the entire text of my testimony and the accompanying written statement be entered into the public record.

Senator FITZGERALD. Without objection.

Mr. CIESIELSKI. Let me preface my remarks with a brief description of my business and how it relates to this hearing. My firm, R.G. Associates, Inc., is primarily an independent investment re-

[1] The prepared statement with an attachment and an accompanying addition to the written statement of Mr. Ciesielski appear in the Appendix on pages 89 and 97 respectively.

search firm and is dedicated to the analysis of corporate accounting issues. We have a small asset management business, but our main focus is the publication of a research service entitled "The Analyst's Accounting Observer," which analyzes and explains accounting trends to both buy-side and sell-side analysts.[1] Frequently, Observer reports are devoted to new or pending pronouncements of the Federal Accounting Standards Board. Our client base of approximately 70 firms is diverse. Readers of our research range from some of the world's largest mutual fund families and well-established brokerage firms and rating agencies, all the way down to money management firms with only a handful of employees and assets under management. In short, our client base is a unique cross-sectional view of the many different kinds of financial statement users.

I have been writing the Observer for over 12 years, and as I have composed reports about new FASB standards, I have had plenty of interaction with the Board and its staff. I have participated in the Board's hearings and roundtables on proposed standards, and as a member of the Financial Accounting Standards Advisory Council and Emerging Issues Task Force, I have had ample opportunity to observe the deliberations and the due process that goes into the development of FASB standards. I have had the chance to see how the standard-setting process benefits from the inputs provided by accounting firms and financial statement preparers—from people who are close to the issues being considered by the Board and whose experience with those issues helps the Board develop more durable standards. In my view, the FASB's system of listening, learning, and then improving their proposals works very well as it exists.

With that, I would like to turn my attention to the purpose of this hearing. On the surface, this hearing is all about an accounting standard dealing with stock options given to employees, but there is a much larger issue that merits our attention. That issue is the independence of the FASB, for if there were not attempts by some parties to legislate action that robs the FASB of its independence, we would not be having this hearing today.

The FASB plays a unique and indispensable function in our country's capital market system—as is the role of any standard setter. Progress in society would be impossible if there were not uniform standards for many of the things we take for granted: For instance, something as simple as the design of electrical outlets. That is what makes the FASB's role critical: By being the independent arbiter of principles at the foundation of financial reporting, investors benefit from financial information that is more comparable and robust than would exist if every preparer had their own way of presenting information.

In my years of observing the standard-setting process, I have seen the Board develop improved accounting standards with an unmatched level of openness and fairness. Their standards will not make everyone happy—in addressing the complicated issues they are charged with, it is impossible to satisfy all parties involved. The reason we are here is because some of FASB's constituents are

[1] "The Analyst's Accounting Observer," appears in the Appendix on page 153.

so unhappy with their attempts to reform the accounting for stock option compensation that they have pulled Congress into the process. They are seeking a legislative answer to an accounting rule they oppose and, in doing so, usurping the FASB's authority to set standards. I believe that the FASB's ability to develop impartial standards resulting in robust information for investors to use would be seriously hampered if legislative intervention becomes the norm for disagreeing with their pronouncements, and a blueprint for such behavior was created the last time the Board attempted to remedy option compensation accounting 10 years ago. While it may benefit a few of the Board's constituents to preserve the present broken accounting model, in the long run our capital markets would likely suffer and result in capital being misallocated in the economy at large.

I would like to focus the remainder of my remarks more specifically on the accounting issue under consideration, arguably the most contentious project ever taken up by the FASB. Despite the claims of vocal opponents, I do not view the FASB's proposal for equity-based compensation accounting as somehow dangerous or reckless. In my judgment, the Board has listened fairly to the views of its constituents and learned much as this project has wended its way from an "invitation to comment" document in 2003 to the exposure draft of a standard at the end of March.

I believe that the issuance of a final standard requiring the recognition of stock option compensation would significantly benefit the users of financial statements. I believe the argument that options cannot be valued and, therefore, should reflect no compensation expense when given to employees is without merit. Companies use option pricing models such as the Black-Scholes model to value illiquid options and warrants they hold in their corporate portfolios. They use them to value options on their stock given as consideration in making acquisitions. Yet they will claim that the same models cannot be used to value options given to employees as compensation. It seems that the only acceptable value such options can have is zero.

Some of the opponents of FASB's proposals claim that the option compensation information should be relegated to a footnote as it is currently displayed. I disagree. The current presentation is a substitution of disclosure in place of paper accounting. It resulted from a Board that was badly compromised in 1994 due to the political actions that interfered with its independence. The information reported in the footnotes since 1996 were real transactions that occurred with employees, and financial statements are supposed to contain transactions that occurred in a firm for a given period. By our count for the S&P 500, net earnings were overstated by more than $175 billion from 1993 to 2002. That is information about transactions which was presented only once a year to investors rather than as it occurred each quarter, and it directly related to the resources under the firm's disposal, which management is supposed to employ for the benefit of its shareholders. That is one of the tenets of capitalism and one that has been ignored when it comes to reporting equity-based compensation.

Opponents of the FASB proposal often claim that stock prices will fall if option compensation is recognized in earnings. I cannot think of a more patronizing argument. Markets are supposed to allow capital to flow to wherever it can best earn the best return. Information about how capital is being managed allows capital providers to make rational investment decisions. If stock prices fall because capital is not being allocated properly in certain firms, then markets are allowing capitalism to function as it should.

For decades, accounting standards have done a poor job in depicting how capital is being used when it comes to equity-based compensation, and consequently, we have seen how capital has been misallocated in the past.

The interference surrounding the FASB equity compensation project is very much like a decade ago, when the Board proposed that health care benefits promised to employees——

Senator FITZGERALD. I'm going to have to ask you to wrap up, because we have to keep on going. We've gone past 5 minutes.

Mr. CIESIELSKI. OK. The situation is similar to the one we had the tussle over accounting for other post-employment benefits. The world didn't come to an end. We now have a referendum on how these things should be managed.

Earlier in my comments I mentioned that a large variety of financial statement users contacted me in connection with the accounting observer. One question that they continually asked from analysts of all stripes is not can we stop this from happening. The most frequent question I hear is when will this go into effect. We want to start adjusting our models.

Investors and analysts are ready now for such information, and would like to roll back the uncertainty that surrounds the way they will do their jobs. That will diminish if the FASB completes its project independently.

Senator FITZGERALD. Thank you very much. Mr. Silvers.

TESTIMONY OF DAMON SILVERS, ASSOCIATE GENERAL COUNSEL, THE AMERICAN FEDERATION OF LABOR-CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL–CIO)

Mr. SILVERS. Thank you, Mr. Chairman. I will do my best at shortening this up. I am here on behalf of the American Federation of Labor and Congress of Industrial Organizations, of our 13 million members who have $5 trillion invested in the capital markets, in retirement plans.

The AFL–CIO strongly supports the Financial Accounting Standards Board in its effort to close the accounting loophole that has allowed corporations to radically understate the trust cost of executive compensation. We strongly oppose S. 9769, S. 1890, and other efforts to exempt stock options from the normal accounting rules and the normal processes by which accounting rules are made.

In the mid-1990's, as many of the previous witnesses have discussed, FASB attempted to require option expensing but was pressured by Congress into abandoning its position. We believe that this thwarting of FASB's role as an independent body was a key contributor to the chain of events that led to the corporate scandals of the last several years that did profound damage to our members and our funds.

Ten years later, there can be no doubt that this issue has been studied to death, most recently by the Congressional Budget Office.

The Big 4 auto firms, the Conference Board, the chairs of the SEC and the PCAOB and every investor organization we are aware of agree, that at long last Congress should simply let FASB do its job.

Against this background, efforts to prevent FASB from acting on its conclusions in the name of further study would simply lead to continued subsidy of excessive executive compensation, and at the cost of undermining the integrity of our accounting rules and the processes by which they're made.

Substantively, the AFL–CIO views stock options as one appropriate form of medium-term compensation for line employees. However, we think options are a poor form of executive compensation because they do not fully expose executives to downside risk in the same way that shareholders are. Options are also an inappropriate substitute for the basic wages and benefits needed to support a family. Not surprisingly, nonexecutive options are generally held by upper income Americans, whose base salaries already meet their fundamental economic needs.

At the height of the stock market boom in 1999, only 1.7 percent of private sector employees received stock options, according to the BLS, and that was heavily concentrated among individuals earning more than $75,000 a year. Only 0.7 percent of those earning under $35,000 received options.

Consequently, the labor movement opposes giving options preferential accounting treatment over other more important employee benefits, such as wages, pensions, or health care. Nonetheless, we do agree with the conclusions of the CBO study, that options expensing will not end option use or anything like that at cash short firms where they make strategic sense. And we're fine with that. We think that's a good thing, that those firms continue to use options.

Two bills in this Congress, S. 1890 and H.R. 3574, purport to require the expensing of stock options for the top five most highly paid executives. However, that is a sham. These bills would require companies using an option pricing model, like Black-Scholes, to assume that the underlying stock prices has zero volatility. This minimum value approach allows companies to set the exercise price of the option equal to the current market price and book the value of the option at zero.

Of course, in real life, the prices of publicly traded stocks are volatile, and these executive stock options have real value. Passing a bill that says that public company stock prices do not move and directing FASB to run an accounting system on that basis is the equivalent of passing a bill saying the Earth does not move around the sun, and then asking NASA to run a space program on that basis. You can do it, but don't be surprised if something crashes.

This slight of hand involving volatility is the latest example of misleading arguments surrounding the technical details of option valuation. My written statement goes into that in detail and I would be happy to answer questions on it.

Today, the executives of the international stock options coalition have one billion dollars in options, in the money option value held, not one penny of which has been expensed. It should not be any mystery as to what their motives are. What is mysterious is how these executives of companies like Texas Instruments and Hewlett-

Packard reconcile the expenditures they are making in the cause of distorting their financial statements against the express wishes of the majority of their shareholders at both companies who voted on this, with those same executives' fiduciary duties of loyalty and care.

What is the bottom line of all of this? Let me refer you to the congressional testimony of former Enron CEO Jeffrey Skilling. As he put it, "You issue stock options to reduce compensation expense and, therefore, increase your profitability." Surely we have learned enough from Enron not to mandate by statute that the Enron approach to not accounting for stock options be the law of the land.

Thank you very much.

Senator FITZGERALD. Thank you very much, Mr. Silvers. Mr. Delves.

TESTIMONY OF DONALD P. DELVES,[1] PRESIDENT, THE DELVES GROUP

Mr. DELVES. Thank you very much, Mr. Chairman.

I have been advising boards of directors and management on executive compensation for almost 20 years. Based on my experience, there is absolutely no question in my mind that we must have an expense for options, and it must be meaningful, significant, and soon. And there is no question that the FASB should decide how that expense will be determined.

Ten years ago, the FASB tried to implement an expense for options. Congress intervened and the FASB backed down. Let's look at the results. Over the last 10 years, executive pay has spiraled out of control, mostly due to excessive grants of stock options. Stock options use has more than tripled and boards of directors have done a poor job of getting more performance from this unprecedented increase in compensation.

I believe that had the FASB been allowed to do its job and implement an expense 10 years ago, we would not be in the mess that we're in today with regard to executive pay and corporate governance.

Now let's look at what's happening around the country today. Because the FASB has put this expense out there, and most companies are taking this seriously, the good news is that in board rooms across the country boards of directors are reexamining their use of stock options and are coming up with new solutions and, in some cases, they're even lowering executive pay.

Boards are asking tougher questions about the true cost of options and what they're getting in exchange for it. For example, we were asked to do an analysis for a company to show the board what the total cost to the shareholders had been of their stock option program. We were able to show that board of directors, over 10 years, $1.2 billion of shareholder wealth had been transferred from shareholders to executives. There was no way that we could have done that using publicly available data.

Now, interestingly, we also showed that same board that, over that 10 year period, had they expensed options using FASB's pro-

[1] The prepared statement of Mr. Delves with an attachment appears in the Appendix on page 100.

posed method, the expense would have been $600 million, roughly half of the total cost to shareholders.

Now, our research shows that we expect that to be true over time and across companies, that roughly 50 percent of the ultimate cost to shareholders will be captured in the accounting expense. However, that expense occurs up front when the options are granted. If it's a high performing company and the stock price goes up, the total cost to shareholders could be much greater. But for the poor performing company, the cost to shareholders could be much lower. It could even be zero.

For that reason, I prefer the intrinsic value method that Mr. Herz discussed, which is the alternative method that is allowed for certain private companies. I think it does a better job of capturing the true cost to shareholders. It would provide better information to board of directors and could result in more creative solutions in executive pay.

However, the debate over how the expense should be determined belongs with the FASB. I look forward to engaging with them in that debate according to their proscribed process.

So, in summary, there must be a significant and meaningful expense for stock options, and FASB must decide how.

Thank you.

Senator FITZGERALD. Thank you, Mr. Delves. Mr. Heesen.

TESTIMONY OF MARK HEESEN,[1] PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. HEESEN. Good afternoon.

I'm going to address this question as it really relates around private companies and newly public companies. That's where the venture capital industry concentrates and that's where 11 percent of the employment opportunities are right now.

Almost without exception, young, growth oriented venture backed companies use options to attract the brightest talent at a time when cash is scarce, just as Senator Bennett was saying. These employees take a considerable risk to work at unproven companies, knowing that through their stock option program they may be rewarded, if and only if the company succeeds.

Should FASB's proposal go through, we believe stock options will be artificially too costly for many of these young companies to offer to all their employees, thus seriously hindering their ability to attract human capital to compete and providing a false picture of their financial health, which will ultimately lengthen their reliance on venture capital.

This is the important point from our angle. The longer these companies stay artificially in the red, the longer it takes our companies to be acceptable to the public. Because there aren't analysts following these kinds of companies, we will have to continue to work with those companies at the expense of putting new money into new companies. That means fewer venture backed companies will be funded, fewer new technologies will be funded, because our industry does not scale. There are only a certain number of venture

[1] The prepared statement of Mr. Heesen appears in the Appendix on page 105.

capitalists who know how to basically grow companies, and they will only be able to do so much in this period.

We have seen this in the past. You will see a reduction in the number of emerging growth companies being funded by venture capital.

One of the largest challenges of mandatory option expensing for small companies is the burden of valuation, which we've been talking about. FASB has put forth three models for valuation. The first two models, Black-Scholes and the lattice method, require a volatility number as a critical input. Yet, the underlying shares of a privately held company have never been liquid, so there is no precedent to derive a volatility number, thus creating a significant and costly accounting quagmire.

When issuing FAS 123 in 1994, FASB agreed. They stated the Board recognizes that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. The Board therefore decided to permit a nonpublic entity to omit expected volatility in determining a value for its options. The result is that a nonpublic entity may use the minimum value method.

Rather than to continue to offer private companies the minimum value method, which sets volatility at zero, FASB now advises these organizations to use Black-Scholes, the lattice method, or as we've been hearing a lot here today, the intrinsic value reporting. We believe that this intrinsic value reporting model really is akin to offering no choice at all.

In its proposal, FASB has modified the intrinsic value calculation to require that the share options and similar options be remeasured at intrinsic value at each reporting period through the date of settlement. Historically, this calculation has taken place only once, recognizing that companies rarely have the information to reset a stock price that is not tradeable. A continuous recalculation of intrinsic value is too costly for most organizations to bear, resulting in invariable accounting which is the result—which experts have recognized is unwieldy and impractical, but a gold mine for newly admitted valuation consultants, accountants, and let's not forget the trial board.

Unfortunately, GAAP is not a matter of choice for private companies. Most start up and report their financials under GAAP because they expect or hope to ultimately move through an initial IPO process or be acquired by a public company. Again, by placing this accounting burden on young companies, FASB is lengthening the reliance on expensive, high risk capital to the start-up sector.

Should FASB move forward with its current stock option accounting mandate, the Board will be acting in direct conflict with its stated goals: "The cost imposed to meet that standard as compared to other alternatives are justified in relation to the overall benefits from improvements in financial reporting." The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small entities because of their limited accounting resources and the need to rely on outside professionals.

As the *Chicago Tribune* stated in its April 6 editorial, "Expensing isn't a panacea for investors and it carries a cost that could hurt entrepreneurship."

Thank you.

Senator FITZGERALD. Thank you.

Before I go on to Mr. Glassman, because I'm from Illinois, I have to respond to the *Chicago Tribune*. I have Mr. Ciesielski's Analyst Accounting Observer Report that shows that the Tribune Company, which owns the *Chicago Tribune*—and I love the *Chicago Tribune*, I've read it all my life, and they always endorse me. They're a wonderful paper.

But the last time I checked, their earnings were overstated more than any other company in my State. According to this report, their earnings in 2003 were overstated by 10 percent by virtue of their failure to expense stock option compensation. They are heavy users of stock option compensation. Their earnings per share, as reported last year, were $2.61. If they had expensed their stock option compensation, it would be $2.38.

I only wanted to disclose that because I thought they should have disclosed that in the editorial they wrote opposing the new FASB rule.

Mr. HEESEN. And I would love to see the *Washington Post* do the same thing, frankly, on the other side, with Mr. Buffett owning a good chunk of the *Washington Post.* That would also be helpful.

Senator FITZGERALD. Mr. Buffett does, and he favors the expensing of stock options——

Mr. HEESEN. And we would never see——

Senator FITZGERALD. Also, I think they have a shareholder there, Donald Graham, who doesn't want to give all his value away necessarily, so he's really watching the company. He's an owner more than just a manager, and he's representing the interests of the owners. We'll leave some time for questioning, though. Mr. Glassman works for the *Washington Post,* but apparently does not share their editorial viewpoint.

Thank you, Mr. Glassman.

TESTIMONY OF JAMES K. GLASSMAN,[1] RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman, and thank you for the kind introductory remarks, Senator Levin.

Let me just comment on what you just said. I obviously have no reaction to what you're saying about the *Washington Post.* I do have a number of very good friends who work for the *Chicago Tribune* at upper management levels, and I can tell you that one of the reasons they are there and diligently working is, indeed, because of their stock options, which they talk to me about all the time.

Let me begin my testimony. One in two American families own stock, and one in eight U.S. private sector workers hold stock options. Senator Lieberman calls this revolutionary democratization. I agree with that.

The FASB proposal of March 31 will adversely affect these Americans. The proposal is likely to depress the value of securities and, for many firms, it will lead to the elimination or reduction of broad-based stock options, 94 percent of which, according to a new study, go to employees below the top management level. Discontinuing or

[1] The prepared statement of Mr. Glassman appears in the Appendix on page 112.

reducing these options programs will have an adverse effect on U.S. competitiveness, innovation, and job creation. It will needlessly damage the U.S. economy.

In 1972, when FASB's predecessor first looked at this question—not 10 years ago, but 1972—it decided against expensing options when issued. The reason, "Because of the concern that stock options could not be reliably valued at the exercise date." That is still true.

Now, the current regime gives investors the information they need in the form of copious material and financial statements. Mr. Chairman, with your permission, I would like to enter into the record—this is the Intel Corporation annual report. You can look at virtually any annual report of a company that issues options. Here under earnings per share it lists the effect of the dilution of stock options, reducing earnings per share, which is what investors care about, and it goes on for three pages with notes on stock options. That's more information than most companies include on things that I think are a lot more important, such as the sources of their revenue, other forms of compensation, patents, debt, all sorts of things. This information is in these annual reports.

Now, I would just like to focus briefly on the issue of FASB's accountability. Much has been made of FASB's independence. But accountants need to be accountable, too. As Mr. Volcker just said, they need to be exposed to the real world—that is, to the people's representatives. America's elected representatives not only have the authority, they have the moral and legal responsibility to oversee the activities of FASB just as they oversee the activities of the SEC, which in 1973 ceded responsibility itself for these standards to FASB.

Now, this does not mean modifying or overruling common, day-to-day decisions. Of course, not. But it does mean carefully examining the impact of a tremendously important decision like this one on options and accounting. This is not interference. This is not intervention. This is not tampering. This is a responsible execution of your job.

FASB has a single mission, which it states this way: "To establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." FASB executives have said clearly that the economic consequences of their decisions do not concern them, and they're right. But you, as Federal policymakers, have a far broader mission: Encouraging economic growth, preserving and increasing jobs, innovation and competitiveness.

Now, even if FASB's expensing proposal were cogent from an accounting and financial viewpoint—and in my opinion it is not—it would be the duty of Congress to consider its economic impact.

Finally, FASB on the one hand states that it is independent, so hands off. On the other, it has been vigorously lobbying. As I believe Senator Enzi originally said, there is an article today in the *Wall Street Journal,* and let me just quote from it, about a conference call yesterday:

"During the conference call Monday, Sir David Tweedy, chairman of the International Accounting Standards Board, said to institutional investors, it would be a 'real disaster' if Congress blocked

FASB. 'We would be horrified if politicians in the United States stepped in,' he said."

Sorry, Sir David. Congress has work to do, and I congratulate you, Mr. Chairman, on holding this hearing and doing that work.

Thank you.

Senator FITZGERALD. Mr. Glassman, thank you.

On your remarks about Intel disclosing their in the money options, they don't disclose in that footnote their stock options that aren't in the money; isn't that correct?

Mr. GLASSMAN. Well, they disclose the number of them that are not in the money. In other words, they say there are—believe it or not, there are a lot of——

Senator FITZGERALD. They're disclosing the dilution, though, in the earnings per share, and they disclose the dilution in the earnings per share of only in the money options.

Mr. GLASSMAN. That is correct. And that is the rule——

Senator FITZGERALD. And then in the footnote, do they show the potential dilution from all the options, not just the ones that are currently in the money?

Mr. GLASSMAN. I'm not sure they make the calculation. I can't actually—I think that they do. But I can tell you that in the P&L, where they do the earnings per share, they show the dilution of stock options that are in the money, and they tell you the number of stock options which are not in the money—By the way, as I remember, I just flipped a page and missed it, but I think I've got it down within a few million. There are 100 million options in the money, and 400 million out of the money. I think this shows the problem, in fact, in trying to value stock options when they are issued.

Unfortunately, as everyone here knows, stock prices have dropped for a lot of tech companies, and a lot of these options are way out of the money.

Mr. HEESEN. They call that super dilution. There have been a lot of companies who said they would love to put that information out. A couple of business periodicals have actually said, if we could do that, that would be fine as an additional part of the disclosure, to put in basically the worst case scenario. If tomorrow, every option you had was exercised, what would that impact be on your company.

Senator FITZGERALD. OK. Just going back to Mr. Glassman, you are on an advisory board for Intel, right?

Mr. GLASSMAN. That is correct.

Senator FITZGERALD. You heard my opening statement where I was quoting from Benjamin Graham's book, "Security Analysis—"

Mr. GLASSMAN. A great book. I congratulate you for quoting from it.

Senator FITZGERALD. I haven't read the whole thing, but I looked up the part on what he called stock option warrants.

Do you agree with him when he said the basic fact about options—he calls them option warrants—is that it represents something which has been taken away from the common stock? The equation is a simple one. The value of the common stock, plus the value of stock options, equals the value of the common stock alone if there were no options.

In other words, if you own a company—let's say you own 100 shares of a company and that is all the company has in outstanding shares—you own all of it. All of a sudden the company gives me 100 options to buy shares in your company. Something has been taken away from you, right? You're going to share equally with me now in the upside participation of any future enhancement or rise in the profitability of the company.

Do you agree with that?

Mr. GLASSMAN. I do agree with it. But what is being taken away is something that is extremely contingent and difficult to value. If you're simply giving out warrants, which are things that anybody can convert immediately into stock, and that are tradeable in most cases, that's one thing. But if you're giving me an option which requires me, for example, to stay in the company and not get fired, not leave for a number of years, and I don't know whether the price is going to go up or down, that's something that is contingent, which I think is handled quite well, and I think has been for decades——

Senator FITZGERALD. I agree it's difficult to value, but depreciation is difficult to measure, the wearing out of a useable life of plant and equipment, that's an age old debate, but it nonetheless is a real expense to a company. As a capital asset runs out of its useful life and approaches obsolescence, the company is actually going to have to expend cash to buy new plant and equipment. It is a real expense and we do try to capture it. We don't argue that we'll just ignore that expense and pretend it doesn't exist, too. The same with pension liabilities, amortization of good will or impairment of good will, and the value of derivatives. Those are all difficult questions, aren't they?

Mr. GLASSMAN. They are difficult questions, there's no doubt about that. I think, however, that we're going down exactly the wrong road here. What we're trying to do is take a lot of information, which is, indeed, provided to investors, and shoehorn it into one number, which is not going to be an accurate number.

I don't think that really helps investors at all. I think the current regime actually helps investors a lot more than trying to pluck a number out of the air, which is almost certainly going to be inaccurate. All but the back testing has shown that whatever system is going to be used is not going to produce accurate numbers. That's the problem.

What I find somewhat ironic, I know that Mr. Herz has made comments in the past about the importance of really getting to work at the true challenge for accounting, which is how, in a knowledge-based economy, can you provide the proper information to investors. I don't think that proper information is one number to represent a very complex phenomenon.

Senator FITZGERALD. OK. I have a meeting I'm going to go to in the anteroom, and I'm now going to turn the questioning over to Senator Levin. Then I'm going to try and come back and continue on with my questions.

Senator LEVIN [presiding]. Mr. Glassman, I think you said somebody from the International Accounting Standards Board said he would be horrified if Congress acted?

Mr. GLASSMAN. He said he would be horrified. He didn't say Congress. He said if politicians—I guess he was referring to Congress—in the United States stepped in.

Senator LEVIN. I thought you said, in introducing that comment, said it was FASB that was lobbying us. Did FASB put them up to it, the IASB?

Mr. GLASSMAN. I don't know if they put them up to it, but there was a joint conference call which FASB, according to the *Wall Street Journal,* held with a number of institutional investors yesterday.

You heard from the testimony, obviously, that part of the impetus here is to have a convergence of international accounting standards and U.S. accounting standards——

Senator LEVIN. That's just stating a position, right? Is that lobbying, what you would call it? If they're just stating their position as to why they're doing what they're doing, and we call them in front of us today and they gave us their position—I just want to find out something else.

Are you suggesting that FASB somehow or other has urged people to lobby for their rule, because I would like to hear from Mr. Herz on that.

Mr. GLASSMAN. I think Mr. Herz will tell you that FASB has at least one full-time lobbyist on its—a registered lobbyist on its staff.

Senator LEVIN. Let's find out what the lobbying is.

Mr. Herz is sitting out there. What lobbying do you do?

Mr. HERZ. Our registered lobbyist is Mr. Mahoney, who is here as a staff person to answer your staff's questions and help prepare my testimony. It is to provide people on the Hill and Federal agencies information when they ask——

Senator LEVIN. OK. I just wanted to clear that up. Anyway, Sir David Tweedy is on the International Accounting Standards Board.

The next question. Is the problem that you two have, Mr. Heesen and Mr. Glassman, is it mainly on the valuation issue, or if they were easily valued, readily valued, would you still object to them because they're such a valuable incentive for folks to join companies and invest their time and so forth? Which is the bigger issue for you?

Mr. HEESEN. We have a fundamental issue with the idea that these should be expensed, that these options——

Senator LEVIN. Even if they were easily valued?

Mr. HEESEN. No. But having said that, under where we are at this point, we believe that the valuation issue is extremely important, particularly for young, privately held companies, where it's almost impossible to come up with a logical number.

Senator LEVIN. Are you saying it's more difficult than other kinds of valuations which we've heard about this afternoon?

Mr. HEESEN. It's more difficult, and it's going to be more costly, particularly for small companies.

Senator LEVIN. More difficult than the convertible bonds and long dated stock warrants and all those other things?

Mr. HEESEN. A young company is not going to be using any of those things. It's great for Cocoa Cola, but we're not in that boat.

Senator LEVIN. But it's more difficult than all the other items that are difficult to value that you heard about today?

Mr. HEESEN. All the other things that a small community would use at the end of the day are going to get trued up. That's the important thing. The stock options, you put them out and that valuation is wrong, it's not going to get trued up at the end of the day. You're going to have to carry it forward with that bad number.

Senator LEVIN. One easy way to do it is the alternative way of valuation. Do you have a problem with that?

Mr. HEESEN. Yes. As I stated in my statement, intrinsic value is not—what we believe, when we looked at it carefully, it is not a way, a proper way of doing accounting.

Senator LEVIN. I was referring to the alternative way which I heard at the end of the testimony by Mr. Herz, about small businesses being able to take the same valuation on their books as they do on their taxes.

Mr. HEESEN. That we have not looked at. I have not specifically looked at that at this point.

Senator LEVIN. I thought that was part of your proposal.

Mr. HEESEN. No. The intrinsic value——

Senator LEVIN. No, something else.

Mr. Herz, what do you call that alternative approach that you were thinking about having small businesses have the option to use? Is that the intrinsic value approach?

Mr. HERZ. Yes.

Senator LEVIN. OK. Thank you. Then I'm wrong. The intrinsic value approach I guess is what they call that.

Mr. HEESEN. Exactly. And as I stated in my statement, what that does is force you, instead of only once, to go out and get a valuation consultant to do this quarterly, so the cost imposed really does not make this a choice at all at the end of the day.

Senator LEVIN. If you were given a choice, if small business were given a choice of simply taking the same figure that they take on their tax returns and putting it on their own books, would that be a problem for you?

Mr. HEESEN. I don't know. We would have to look at that.

Senator LEVIN. Well, it's been out there for 10 years, Mr. Heesen. I've been around and around with folks on that issue for 10 years, and then people say they've got to take a look at it.

Mr. HEESEN. Well, the difference is——

Senator LEVIN. Logically, is there any problem with that?

Mr. HEESEN. I don't know, because tax accounting is very different, as the chairman of FASB said, as opposed to accounting.

Senator LEVIN. It usually is. But if you're looking for certainty and you want to make sure that no one is trying to figure out how to do something in advance which is difficult to assess, then one way to do it is to say, OK, we'll give you a choice. You can either take it the complicated way, which you think is a complicated way, or you can take it the simple way, which is, if you want a tax deduction for a business expense, show that on your books. That's real simple.

You're not telling me that you're willing to do that?

Mr. HEESEN. We would have to look at that. I'm not going to say that a small business, when they have all these other issues in front of them, is going to take that very quickly. I don't know.

Senator LEVIN. OK. Will you let the Subcommittee know?

Mr. HEESEN. Absolutely.[1]

Senator LEVIN. Mr. Glassman, do you have a problem with that?

Mr. GLASSMAN. No. I think that, just as a principle, I think tax accounting, and whatever we want to call this reporting accounting, GAAP accounting, ought to be as close as possible to the same thing.

Senator LEVIN. So that if we gave small businesses, let's say, an option of putting the same business expense on their books as they take as a tax deduction on their taxes, you would say that makes good sense to you?

Mr. GLASSMAN. I guess I would have to answer the question in a broader way, which is that tax accounting and GAAP accounting should be the same. But I think that would mean we would need to look at the entire Tax Code as a result. I think we should, but——

Senator LEVIN. I don't know that we're going to be able to look at the entire Tax Code as a result of looking at one bill. Since that's your general principle, would you apply it here?

Mr. GLASSMAN. Yes.

Senator LEVIN. OK. That's helpful. I think that's going to be a very useful alternative, and I predict to you what the outcome will be when we consider that alternative. It will be the same throwing up of hands and saying no, we don't want to do that. That's even worse than what FASB is proposing, because that frequently is a bigger number than what FASB is proposing. But I will predict right now, Mr. Heesen—I shouldn't predict your answer, but I look forward to your answer with unbaited breath.

Now, the only reason I say that, by the way, is because I've been around that track before. About 10 years ago I made that suggestion, and the immediate instinct was hey, that makes sense, and then within 24 hours, folks who opposed FASB came back and said they're very much opposed to that. I hope your answer is different.

Mr. HEESEN. And I'm looking at it from a small business perspective, not from probably the people you were talking about, from the bigger companies 10 years ago.

Senator LEVIN. No, these weren't the bigger companies. These were start-up companies. OK. At any rate, thank you for getting back on that.

The only other question I think I will ask before I ask our Chairman to come back is the numbers, Mr. Glassman, that you gave us, and then I would like to talk to Mr. Silvers about the number of workers that hold stock options in the private sector. You said one in eight employees in the private sector——

Mr. GLASSMAN. Yes. This is in my written testimony.

Senator LEVIN. It was a Harvard study or something——

Mr. GLASSMAN. You had two Rutgers professors and one Harvard professor.

Senator LEVIN. OK. Then it's a Rutgers study in that case.

Mr. Silvers, is that your experience at the AFL–CIO, about the one in eight?

[1] Letter of clarification from Mr. Heesen, dated Apri. 30, 2004, appears in the Appendix on page 152.

Mr. SILVERS. That's about 12 percent. That doesn't sound off the track. The professor, Professor Blasi at Rutgers, is a recognized expert in this area.

Senator LEVIN. In the one question I have on that study, are these people who own stock options as a result of getting them at work as part of their compensation?

Mr Glassman. Yes, sir. It's part of the compensation stock options. Actually, it's very interesting because the figure that they use is 13 percent. I just made it one out of eight, which is 12½ percent, including 57 percent of workers in computer services, 43 percent of workers in communications, and 27 percent in the finance industry.

Senator LEVIN. And that other figure that you cite, 94 percent of options being held by employees below the top levels of management?

Mr. GLASSMAN. That also comes from the same study.

Senator LEVIN. What is that level? That's a much different——

Mr. GLASSMAN. Actually, I don't know that.

Mr. SILVERS. Senator, if I might, I think part of the confusion here is that the 94 percent number is broad-based plans. If you look at all options, I believe the correct number is the National Center for Employee Ownership number that Senator Lieberman mentioned earlier in the hearing, which is, I guess, about 70 percent of the options that are out there in total, that are issued by employers to employees at all levels, are held by the very top level of management.

Senator LEVIN. And do we know how "top level" is defined?

Mr. SILVERS. I believe in that number—I'm not sure. My guess is that number is looking at the SEC disclosing top five executives. I may be wrong, though. It may be a slightly larger slice.

Mr. GLASSMAN. I'm pretty sure that is correct.

Actually, if I could just intervene for a second, you asked me the same question you asked Mr. Heesen. I think this would be my answer to your original question, which is more important. I think it's very important that more and more Americans have the opportunity to own stock options and other ways to participate in ownership of the companies that they work for.

Senator LEVIN. I agree.

Mr. GLASSMAN. I think that's a great thing, and this——

Senator LEVIN. I think all of us would agree with that.

Mr. GLASSMAN. Clearly, according to just about everyone who has opined on this subject, from whatever position, this will discourage that. There is no doubt about that. I think you can take that into——

Senator LEVIN. How about grants of stock?

Mr. GLASSMAN. I like grants of stock. The problem with grants of stock is that they do not provide as much of an incentive to many employees as options, because there's much more leverage in options, obviously.

Senator LEVIN. Say you have a stock grant that is conditioned upon the company reaching certain levels.

Mr. GLASSMAN. I think that's fine, and I really do believe that——

Senator LEVIN. Is that treated as compensation on the books?

Mr. GLASSMAN. I don't know the answer to that.

Mr. HEESEN. Yes, it is.

Senator LEVIN. Sure, it is. So why is this different? They're both valuable.

By the way, I agree with you. I'm all for stock grants conditioned on companies doing well. I think it's great. I'm a big Aesop man. Russell Long taught us about that. I believe in stock options. I think it's fine. The only question is how you account for them, and why would we want to account differently for conditional stock grants on how a company does and stock options based on how a company does? What's the logic in treating those two things differently? Mr. Glassman.

I'm stalling here while our Chairman comes in.

Mr. GLASSMAN. It's a good question. I guess I would turn the question around and say, why do we need to make a change if this information is broadly available to investors and anyone else who wants to make a decision about valuing a company. It's all right there. By making the change, you are actually going to incent businesses or push businesses into abandoning these programs, which are good programs.

Senator LEVIN. The reason for the change is honest accounting according to the Independent Accounting Board. That's the reason for the change. The answer to the question is how do you logically treat those two conditional grants differently. In fact, as I understand it, even a grant of a stock option dependent upon whether a company does certain things or the stock goes up in value is also valued under current law, under current standards.

The one exception to all these uncertain types of compensation, the one exception is stock options. If I tell you, if you will come with my company, you're going to get a thousand shares of stock, if you can double the value of this stock within the next 10 years, at any time during that 10 years, that grant, conditional as it is, uncertain as it is—we don't know if the company stock is going to go up or down or not—but I offer that to you to get you to come to my company, to be an executive at my company, that is expensed now. But the stock option isn't, and there is no logical basis that I can see for differentiating there, and there's no reason why we ought to say you get a tax deduction for the expense but you don't have to show the expense on your books.

Why should we then give a tax deduction? If you want the accounting to be the same, OK, maybe we then ought to say you don't get a tax deduction. Would that then satisfy your rule about keeping tax accounting the same as regular accounting? You don't get a tax deduction?

Mr. GLASSMAN. Well, the tax deduction doesn't come until the end——

Senator LEVIN. Right. But it's still not shown as an expense on your books. Wouldn't we then, to follow your rule, say OK, we won't show it as an expense on the books, but we're not going to give you an expense on your taxes, either. That would then be consistent with your generic accounting principle, would it not?

Mr. GLASSMAN. I guess it would. I think those things ought to be consistent. But I think the main principle here is that broad based stock options have been tremendously beneficial to the U.S.

economy, whether they're exactly in concert with this kind of incredibly complex GAAP accounting system we have now, with some other instrument or not. They are very valuable in real life to our real economy. This measure will cause companies, will certainly incent companies, to abandon these programs.

I must tell you, I don't think that's very good. I do think this is the responsibility of Congress to examine and to see what it can do about it. I don't think that in any way impairs the independence of FASB, not in the least.

Senator LEVIN. I'm for incentive pay of any kind, frankly. I think it does perform a very important economic function, subject to some of the qualifications which Mr. Silvers put out there, too, where the main beneficiaries are, depending upon how you incentivize it. But I happen to agree with the principle that incentive pay is a good thing, but that is the only form of incentive pay which is treated the way it is. That makes no sense——

Mr. GLASSMAN. Well, maybe all the other ones should be treated the same way that options are, because I think, as public policy, we want to encourage this. We really do. We don't want to encourage companies to be sloppy and to take undue risks and to do all sorts of other things, so we would have to watch it. But in general, we want to encourage this kind of practice, and this will discourage it. That's my only message.

Senator LEVIN. Thank you.

Senator FITZGERALD [presiding]. Senator Levin, thank you for covering for me.

I now would ask for unanimous consent—and I will grant it to myself—to introduce Mr. Ciesielski's April 2004 Analyst's Accounting Observer Report into the record.[1]

You developed tables, and one table shows the 50 companies whose unreported stock compensation caused earnings to be overstated by 10 percent or more, ranked by descending order of overstatement.

The company which most overstated its earnings was Yahoo!. It overstated its earnings by 640 percent. You derived that calculation by looking at their earnings per share as reported, which was 37 cents per share in 2003, but if they had expensed, I assume, using the Black-Scholes model—is that right?

Mr. CIESIELSKI. I believe that's what they used. Only a handful had used other than binomial, and I can remember those.

Senator FITZGERALD. OK. If they expensed their stock option compensation, their earnings per share would have been reduced from 37 cents a share to 5 cents a share. So their overstatement of their earnings to the public was 640 percent. That's a pretty whopping deception in my judgment.

But when you think about it, I noticed just looking last night on the computer, it looked like Yahoo! was now selling at a trailing 12-month PE of 128, which is a humongous PE. But that PE assumes that their real earnings were their reported earnings. If one looks at their real earnings as their earnings as reported minus an expense item for stock option compensation—if I were to do the math on their closing price at December 31, their closing price was

[1] "The Analyst's Accounting Observer," appears in the Appendix on page 153.

$45.03, and their earnings per share were 5 cents a share—then their PE at December 31, 2003 looks to me to have been 900. So am I correct, that investors would be paying $900 to get a claim to one dollar's worth of earnings?

Mr. CIESIELSKI. That's the linear math, yes.

Senator FITZGERALD. Am I doing that——

Mr. CIESIELSKI. I think you're doing that correctly. I don't have a calculator to verify, but it sounds like it's in the ballpark.

EVENING SESSION [6 p.m.]

Senator FITZGERALD. Now, going back, Mr. Glassman, to where we were talking about—you said you agreed with Benjamin Graham's analysis, that the value of common stock plus options equals the value of common stock if there were no options.

Let's assume the new FASB rule does deter companies from issuing as many options. Let's assume it deters them from issuing options altogether and a company like Yahoo! stops issuing options. I don't think that will happen. I think they will just start expensing them and be more discreet about issuing them. They won't be gorging themselves on stock options any more.

Going back to that company that you and I talked about that had 100 shares, and you own all the shares, and we no longer give 100 options to me or anybody else in your company. Then aren't your 100 shares in your company worth more because you're back to having a 100 percent claim on the future earnings of your company, and you're not giving options to participate in the future appreciation to anyone else? Wouldn't your shares be worth more?

Mr. GLASSMAN. Well, except for the fact that my company, the company whose shares I own, would not have been able to attract the kind of people that Yahoo! has attracted, that Microsoft has attracted, that Intel has attracted, that Dell has attracted, because of employee broad-based stock options. I mean, this is the reason these options are offered. They are offered to attract really good people. I think anyone in Silicon Valley will tell you——

Senator FITZGERALD. Where are these employees going to go, though, in the new world where the same accounting rules apply to everybody?

Mr. GLASSMAN. I hope the new world is competitive so that we don't have converging—we could do that with the tax codes, too.

Can I just comment on what Mr. Ciesielski's work——

Senator FITZGERALD. But isn't it possible your stock price could go up because now there's no longer these options out there diluting you?

Mr. GLASSMAN. Maybe. It really depends on what investors think. If all of a sudden Yahoo! said "well, we're giving up our stock options; we don't think they're going to work", investors may feel well, that's fine, so now the value is higher or it's the same. But they may get very distressed by it and say, well, that happens, and then Google is going to take all the good people that Yahoo! had.

This issue of Mr. Ciesielski's work, where he found the 640 percent overstatement, the information that he got, I'm pretty sure, is public information. Every investor, every smart analyst like Mr. Ciesielski, is——

Senator FITZGERALD. But he had to spend a lot of time and he has been a life time professional doing this. Do you think the average guy could do this?

Mr. GLASSMAN. Well, guess what? He just published it. So one would expect that other people then get the information. It's the way markets work.

Senator FITZGERALD. They pay him.

Mr. GLASSMAN. According to your theory, that would drive the price of this stock down to virtually nothing, or certainly about a sixth of its value. But the fact is people already know about this.

Senator FITZGERALD. I think you're right, and that's why I don't think stock prices will necessarily go down. In fact, I think they may go up because the shareholders of Yahoo! will then get all of the future rise in the value of the company which inherently belongs to them anyway. They won't have to give a part of their stake in the future of the company to anyone else, so I think their stock could actually go up.

Let's go back to Mr. Heesen. Initially you said the longer a company stays artificially in the red—I don't agree with you that it's artificially in the red; I think it's artificially in the black when you are bringing them to the market now, and I think we will have a more accurate picture once the FASB rules go into effect. But you said it will take longer to bring them public.

But don't you think that I should be, as a government policy maker, concerned not just about the venture capitalists—who want to unload their investment on the public, close out their fund, and make a big return—but about the people out there who are going to buy the shares in this company that you're going to try to unload on them?

Mr. HEESEN. Absolutely. If you look at the venture-backed companies versus nonventure-backed companies on NASDAQ, they have traditionally done much better. So if you're going to be looking at companies between whether they're venture backed or not venture backed——

Senator FITZGERALD. Over how long a period?

Mr. HEESEN. That's been historical for 20 or 30 years, since the venture capital industry has been in existence by and large.

Senator FITZGERALD. They've done better than other companies for how long, though, after they've gone public?

Mr. HEESEN. They have consistently gone—going out, and long run, because they are——

Senator FITZGERALD. Twenty, 30 years down the road companies that had venture capitalists at the start?

Mr. HEESEN. When you look at the Federal Expresses, the Cisco's, the Intels, the entire buyer technology industry, literally has all been financed by venture capital at one point or another. Those are the companies that are driving this economy and continue to drive it.

Just this quarter, you look at the venture-backed IPOs that went out, there were 13 venture-backed IPOs. One of those was the biggest venture-backed IPO ever that went public in the United States. Unfortunately, it's a Chinese semiconductor company, so that's how we're starting to see the changes here, and that company is giving options and it's going to be a very effective company.

And you know what? All the institutional investors like that company and they're putting money into it and it's doing very well right now. That's kind of where we're going in this environment.

Senator FITZGERALD. Mr. Delves, you looked like you had your hand up.

Mr. DELVES. Yes, thank you. I wanted to make a comment on the discussion you were having with Mr. Glassman. You were debating the cost to shareholders of stock options versus the benefits to shareholders of the incentive provided by options. That debate can't happen and doesn't happen, and hasn't happened, in board rooms because there's no expense for stock options.

With an expense for stock options, boards of directors can now start having that debate and balance the cost versus benefits to shareholders.

Mr. HEESEN. I would disagree on that from a small company perspective, in the respect that venture capitalists happily dilute their ownership in a company, and knowingly do that, to give those options to employees, because they know at the end of the day those companies are going to grow as a result of it.

Senator FITZGERALD. But it also, as you said, allows you to bring a company to an IPO sooner.

Mr. HEESEN. Yes, but also, if you look at——

Senator FITZGERALD. So you have a good reason to suffer that dilution because, otherwise, you might have to hold on to it longer.

Mr. HEESEN. Yes, but as a Harvard study 2 years ago put out, a venture backed company actually takes longer to go public than a nonventure backed company, contrary to popular belief.

Senator FITZGERALD. Now, I know venture capitalists all over the country; I know people in the Texas Pacific Group out West; I know the Madison Dearborn Partners people in my State. I know Ned Heiser, who brought——

Mr. HEESEN. Most of the buyouts are not venture capital, but——

Senator FITZGERALD [continuing]. Federal Express public many years ago. And I know Thayer Capital, the Carlyle Group, and so forth. The venture capitalists I have talked to from the Midwest and the East have had a different approach than those coming from the Silicon Valley area—the Kleiner, Perkins of the world—that are very heavily invested in high tech. I do think there's a big difference between the midwestern venture capitalists. They are simply not as concerned about the expensing of stock options as the ones out West, based on——

Mr. HEESEN. Well, I think that's a definitional issue, in that venture capital in the Midwest is more buyouts, to be perfectly honest, than it is true venture capital.

The other unfortunate thing there is when you look at a Milken study that just came out last week, you look at where they are looking at, where are the next science and technology centers in the country are going to be, and they rated each State. In the Midwest, there was only one State in the Midwest, Minnesota, that broke the top 20, in the ability to attract companies that are science and technology based to their States. Maybe there is something that the middle part of the country should be looking at, that the East coast and West coast have been.

Senator FITZGERALD. Clearly, there is a much greater reliance on options in the high tech industry. The overstatement of the earnings of the top 100 NASDAQ firms, last year was 44 percent, I think it was.

Mr. CIESIELSKI. I didn't do that study.

Senator FITZGERALD. No, I think that was Bear Sterns' analysts who did that study. It's high tech firms primarily and a few other industries that rely so heavily on options.

Going back to Jeffrey Skilling's testimony, who brought up the Skilling's testimony? Mr. Silvers, I'll let you comment on this.

I remember him testifying. We were talking about how the executives at Enron, the top 29 executives cashed out a billion one in options in the 3 years before the company's stock collapsed and it filed for bankruptcy, and there was a pattern that I detected of executives cashing in their options and then leaving the company. Remember the Army Secretary, Tom White, he cashed out his options and left? The fellow who committed suicide, unfortunately, Frank Baxter, he cashed out his options and had left the company? Skilling, of course, cashed out $70 million in options in 1991, and then left the company in July or August.

Ken Lay cashed out about $250 million in options and had lined up a job apparently as the CEO of another company. He had to come back as CEO at Enron because otherwise he was left holding the bag.

The one who blew the whistle in the Enron case, came forward, they had made a mistake. They allowed an executive into Fastow's office who didn't have stock options. Her name was Sharon Watkins. She wrote that famous memo, "I ain't getting nothing out of this. Why am I going to go along with the deception?" Implying that everyone else was going along with the deception. It was a very simple Ponzi operation and the company was borrowing money and booking it as earnings. Almost all their transactions boiled down to that, and they parked the borrowings on off-the-books partnerships, but they would borrow money and book it as earnings. They had very little in the way of legitimate operations that I could tell.

They were doing this, in my judgment, because they were getting very rich very quickly, pumping up their share prices, cashing in their options, and then they leave the company before the whole house of cards collapsed.

We were talking to Skilling about the options and the fact that they were taking tax deductions for it, that they were just gorging themselves on stock options, and that there is no expense being reported for that so their earnings were grossly overstated, just by virtue of their failure to expense options. Skilling came right back at us and said, I agree, the accounting rules are absurd, but it's Congress that interfered with FASB that allowed that to go on, so you should be looking in the mirror.

Now, I wasn't in the Senate when that happened. Senator Lieberman was leading the fight against FASB back in those days. Believe me, we met with a lot of ordinary shareholders who really got taken in by that whole scam. They lost all their life savings, and all the employees who had been encouraged by company executives to keep buying Enron stock and tucking it into their 401(K) plan, they lost everything. A lot of people lost everything on that. A lot of that was due to the incentives of the excessive issuance of options, in my judgment.

Mr. Silvers.

Mr. SILVERS. Senator, let me say that in the AFL–CIO I represented a number of those people who were the victims of that situation, who were left with nothing but severance, and not even that. We were very proud to do that. I think they would have a view on some of these discussions.

There are systematic reasons why options tended the direction you indicated. This is why in the brief formal testimony I gave I indicated we feel that options are an inferior form of executive compensation. It's not just that the accounting is not correct; it's that substantively they're not a good form of executive compensation.

The reason is—and some of the reasons are fixable, meaning that the typical executive stock option is a three-vesting period, historically. Some of that is changing right now. That could be changed easily. That 3-year period makes it pretty easy to cash out and leave. To manage the company with an eye towards maximizing your cash out at that moment, it's a pretty bad thing from the perspective of a pension fund that's holding the company long term.

But there are other aspects of stock options that simply cannot be fixed in relation to this problem, which is why we favor restricted stock as a means of linking—long-term restricted stock as a means of linking paid performance.

Senator FITZGERALD. Explain the difference between restricted stock and stock options.

Mr. SILVERS. Restricted stock is simply stock in the company. It is not an option. It is only the upside. You have the full exposure to the upside and the downside. The restrictions around restricted stock are similar and can be stronger than those associated with options, restrictions in terms of when you can sell it, in terms of vesting periods and so forth.

The critical difference here is that when an executive is not exposed——

Senator FITZGERALD. If you have restricted stock, then you don't just have a call on the future price.

Mr. SILVERS. Precisely. You have——

Senator FITZGERALD. If the stock goes down—it's a two-way elevator.

Mr. SILVERS. A two-way elevator, exactly.

Mr. GLASSMAN. No, it's exactly the opposite. If you're given restricted stock—anybody can buy stock, and then there's a downside. But the way restricted stock works is that you are given the stock. So let's say you're given the stock at $20, you pay zero, usually, and now it goes down to $15, now you've got $15, which you never had before. That's the difference.

In fact, if the stock price goes down and you've got an option, you've got zero.

Senator FITZGERALD. So it's really no better than options, except that it does have to be expensed.

Mr. GLASSMAN. It's not better. It's not worse. It's a choice. With options, basically you're getting more leverage. In other words, if it goes up, you make a lot more. If it goes down, you make nothing.

Senator FITZGERALD. OK. What's the public policy rationale for requiring issuance of restricted stock to be expensed but not the issuance of stock options?

Mr. HEESEN. In our view, it's pay for—in restricted stock, it doesn't matter. You get it today at $20, you've got $20, and if it goes down to $10, you still have $10. If you work a little hard, it might get up to $30. But if you have an option, you have nothing until——

Senator FITZGERALD. But we require the issuance of restricted stock to be expensed because we recognize we're taking away something from the company.

Mr. HEESEN. You are taking from the company at that point, exactly. That's a very different thing than an option.

Senator FITZGERALD. You don't think they're taking anything from the shareholders?

Mr. HEESEN. Dilution, absolutely. And we talk about that, and that's why when we look at this, we look at shareholder dilution as being the main key here.

Mr. SILVERS. Senator, these gentleman are simply wrong. Let me explain why, if they will allow me to do so without being interrupted.

Senator FITZGERALD. OK. You go ahead.

Mr. SILVERS. As a shareholder, you care a great deal if your company is in trouble, whether at the end of the day the value of your stock—for example, say you bought it at $40. If the company is in trouble, you care a great deal about whether or not at the end of the day the stock price is $10, $20 or $30. It makes a big difference.

If you hold an option and the exercise price is at $40, and the company gets in trouble, you don't care. It's true that options involve a lot of leverage, and perhaps leverage is a good thing. That's a public policy decision that I disagree with. But what they're wrong about is that options are a better of way of aligning the interests of executives with the interests of shareholders in a stressed situation, which is what Enron was. The reason why options encourage people to cheat and lie in distressed situations is because financially, if they can somehow get the stock price over the exercise price, they win. And it doesn't matter to them if the true value of the company——

You see, if the true value of the company is, say, 30, and it's trading—they know it's 30 and they're insiders—and it's trading at 40, they have got to figure out some way to get that thing over 40 long enough to exercise. If they do that, they win.

Senator FITZGERALD. And then they dump the stock.

Mr. SILVERS. Yes. But even if the strategy they have for getting it over 40 is so risky, that it's actually money losing—for instance, cheating, that's very risky. If you're caught cheating, things tend to collapse completely and all the value drains out of the firm.

WorldCom, for example, is a classic instance of this. There was real value in WorldCom. They cheated and they blew it up. This is why stock options are so dangerous to our corporate governance system as opposed to restricted stock.

I would like to also add another point here, which is again——

Senator FITZGERALD. And you favor the FASB rules that impose discipline on their issuance. You don't favor doing away with the stock options?

Mr. SILVERS. What we favor is the replacement—I think there are unique issues involved in private companies, in their transition issues, and I think those are complex and the FASB process ought to deal with them.

In terms of public companies, we favor restricted stock over options. We don't favor banning options as a statutory matter. We believe that if they are properly accounted for, that the corporate governance process will act to reduce their use and substitute restricted stock for them. In fact, that is what is going on right now.

Senator I would also add, if you will allow me, that a great deal has been made in this debate of two points by the opponents of stock options expensing. One point is the notion that the information is already there and so it's not necessary. The other point is the notion that, if it's expensed, somehow managerial practices in relation to options will change radically, particularly with respect to broad-based options at companies that are cash limited.

You can't hold those two positions simultaneously. Either one or the other has to be true. Both cannot be. If you believe that the one that's true is that there will be radical managerial behavior changes as a result of option expensing, what you're actually saying is that the current accounting rules, and what some would urge the public policy and law of the United States should be, is that we will, by hiding the true cost of stock options, subsidize that form of employee compensation. And some arguments have been put forward for why we should subsidize them.

I would suggest that if we're subsidizing employee compensation, we might not want to focus on a form of compensation 70 percent of which is going to the top five officers, and that perhaps we might want to look at things like the 40 million Americans who have no health care if we were in the business of subsidizing one form of employee compensation over another.

Senator FITZGERALD. Mr. Heesen, do you personally own any stock options in any companies?

Mr. HEESEN. No.

Senator FITZGERALD. Mr. Glassman.

Mr. GLASSMAN. I have to say that I made a very lucrative deal with my partner, the former Chairman of the SEC, Arthur Levitt, when we were partners in *Roll Call*, which is a congressional newspaper. It is not a publicly traded company, but my incentive was, indeed, options. I had options to buy shares of the company, which originally Arthur owned most of, and I did so, and we eventually sold the company.

I can tell you that the spur of options was quite substantial to me. I think it was very important. I certainly can sympathize with people, with the 14 million Americans who own stock options. I think it's a good thing.

By the way, I just want to be clear, Mr. Silvers, I am not wrong. The reason that I intervened was because you were saying something that was incorrect about restricted stock. In fact, if you get restricted stock and the price goes down, you lose whatever the price decline was, but if you get options and the price goes down, you get nothing. That's the whole point.

I absolutely did not say—and I'm not sure whether Mr. Heesen did—I absolutely did not say that I prefer one over the other. Quite the contrary. I think that those are decisions that need to be made by businesses themselves, their boards of directors and their shareholders: What is the best way to compensate employees. Sometimes it's restricted stock; sometimes, as in the case of Warren Buffett, whose stock I own——

Senator FITZGERALD. But you favor accounting rules that would prefer stock options to any other form of compensation?

Mr. GLASSMAN. I think that's another—I think that's a different issue.

Senator FITZGERALD. You don't think the accounting rules should be neutral, though. You believe that all employee compensation should be expensed, except stock options, correct?

Mr. GLASSMAN. I think that the current regime, which handles the very thorny issue of how to value stock options, by providing investors with the kind of information I just showed from the Intel statement and for just about any other statement you want to look at, is the best way to do it. That is my belief right now, and that we don't need this change.

Senator FITZGERALD. Mr. Delves, very quickly, and then I will have to adjourn the hearing. I absolutely have to leave.

Mr. DELVES. Thank you very much.

My point is that it is not this simple. This is what I do for a living, as I design incentives. Stock options work. They make people take more risks than they ordinarily would. If you grant too many of them, they take too many risks.

Senator FITZGERALD. Performance stock options are better, though, right?

Mr. DELVES. Anything tied to performance is better, including restricted stock.

Senator FITZGERALD. But we require performance stock options to be expensed, but not ones that are not tied to performance?

Mr. DELVES. That's correct.

Senator FITZGERALD. So sometimes the stock options that maybe come into money just because the economy is good and the market is going up, it's like rewarding the weatherman because the weather turns out well.

Mr. DELVES. If we don't have an expense, we can't make the tradeoffs between one type of incentive versus another and come up with the best one.

Senator FITZGERALD. Thank you. All of you have been wonderful witnesses. You have been great, and I wish we could have had another hour, but we do not.

The record will remain open until the close of business next Tuesday, April 27, for any additional statements or questions.

If there is no further business to come before the Subcommittee, this hearing is now adjourned. Thank you all very much.

[Whereupon, at 6:25 p.m., the Subcommittee adjourned.]

APPENDIX

Statement of Senator Michael B. Enzi

"Oversight Hearing on Expensing Stock Options:
Supporting and Strengthening the Independence
of the Financial Accounting Standards Board"

U.S. Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget,
and International Security

Tuesday, April 20, 2004
2:30 p.m.

Mr. Chairman, Senator Akaka and Committee members, thank you for this opportunity to testify before you on the issue of expensing stock options. I am here to speak solely on behalf of the millions of small businesses in the United States who may or may not be aware of the recent proposal by the Financial Accounting Standards Board (FASB) to require the expensing of stock options.

Small businesses in the United States number nearly 23 million strong and they represent 99.7 percent of all employers. They employ half of all private sector employees and generate 60 percent of net new jobs annually. In addition, small businesses produce 13 to 14 times more patents per employee than large patenting firms. It is not an exaggeration to say that the health and strength of our nation's economy rests on the ability of small businesses to start and grow.

Our nation's entrepreneurial spirit and climate are the envy of the world. Many countries are trying to replicate our small business system. In fact, news articles of late last year showed that China was trying to build its own Silicon Valley. We must be very careful to avoid any unintended consequences that might disrupt small business and job creation.

I wanted to appear before you to voice the concerns of small businesses around the country that I believe are being overlooked or pushed aside as not relevant to the discussion of stock option expensing. At first glance, the question of whether to expense stock options appears to be a very simple and media friendly question. However, before getting to the question of expensing stock options, one must first ask how those options will be valued. That is important because, as we have hear it said so many times, the devil is in the details.

To fully understand the implications of the recent proposal by FASB, one must be well versed in the differences between the fair value method, the intrinsic value method, lattice structures, and binomial and Black Scholes expensing valuation models.

As a trained accountant, I have found that these terms are not generally in use in the accounting world but are unique to this particular accounting proposal. For small business owners and their accountants that are encountering these terms for the very first time, the evaluation of the FASB proposal must be daunting and intimidating.

The valuation approach as proposed by FASB would turn the American dream of running a small businesses into a nightmare. The proposal itself is more than 230 pages long including appendixes. Rather than addressing small business concerns head-on, FASB has just thrown together a series of criteria for small businesses to consider. Small businesses have no choice but to hire expensive experts to delve into the Voodoo valuation. Some believe that only the largest accounting firms would be able to produce the proper valuation models and maybe even charge upwards of $500,000 for them. Both small businesses and small accountants would be victims of the FASB proposal.

A frequent concern heard by the Government Affairs Committee is that small business owners are very busy building and running their businesses and they cannot pay attention to the many federal regulators in Washington, DC. For this sole reason, Congress created the Regulatory Flexibility and the Small Business Regulatory Enforcement Fairness Acts. These Administrative Procedure Act laws require federal regulatory agencies to undertake economic analyses when a proposed regulation may disproportionately burden small entities. In addition, the laws require agencies to conduct vigorous outreach and to establish compliance assistance for small businesses.

FASB as an independent standard setter is not bound by the Regulatory Flexibility nor the Small Business Regulatory Enforcement Fairness Acts. Accordingly, FASB, as a standards setter recognized by the federal government, should establish equivalent small business review practices for itself.
In November, I held a hearing in the Committee on Banking, Housing, Urban Development entitled, "Financial Accounting Standards Board and Small Business Growth". At that hearing, we heard from a number of witnesses that FASB's consideration of small business concerns on a variety of FASB proposals was severely deficient. At the hearing, I requested that a Small Business Advisory Committee be established by FASB to listen to and address small business concerns. I envisioned this Committee would operate in the same manner as the NASD's Small Firm Advisory Board in that all proposals would be reviewed and evaluated by the Committee. FASB has indicated to me that the Small Business Advisory Committee would meet twice a year and would receive proposals only on an ad-hoc basis. While I am pleased that FASB has established the Committee, I still have serious doubts about FASB's commitment to listening to the small business issues.

For example, immediately following the hearing, FASB conducted field tests with eighteen businesses on stock option expensing. None of those businesses were small businesses.

As FASB is rushing to implement the proposal on stock option expensing by the end of the year, I am very much concerned that small business issues will be pushed aside or not addressed at all. For example, the proposal will apply not only to publicly traded companies but also to privately-held companies. Many of these privately-held companies are startups and very small companies and many that I have spoken to recently are completely unaware that this proposal would apply to them. In addition, FASB, without advance warning, extended the proposal to include small companies with employee stock purchase plans.

While some of the companies will be able to participate in the two roundtables to be held by FASB in Connecticut and California, thousands of others may not find out about the roundtables until it is too late. In addition, the first meeting of the Small Business Advisory Committee is on May 11th. An issue as complex as this may not be addressed fully, however, it is quite possible that the Committee could spend all day on the proposal's glossary of terms and have very little time to discuss anything else.

For this reason, a hearing has been scheduled next week in the Committee on Small Business and Entrepreneurship that will give a limited number of small businesses a chance to discuss the proposal on stock option expensing.

As the Government Affairs Committee has jurisdiction over the Regulatory Flexibility and the Small Business Regulatory Enforcement Fairness Acts, I will leave the Committee with a couple of questions that I hope that you will consider exploring in this hearing:

1) What are the duties and responsibilities of a standard setter recognized by the federal government for analyzing the economic impact of proposals? Should those duties and responsibilities rise to the level of the statutory mandates of federal agencies?

2) What is the level of outreach that is required to ensure that small businesses throughout the country are able to participate in the standard setting process? And,

3) What is the remedy available to a small business that believes that the independent standard setter got the standard wrong for small businesses or that the standard setter has completely pushed aside small business concerns? Small businesses pursuant to the Regulatory Flexibility Act may sue a federal agency to set aside a rule proposal if the small business has been unjustly aggrieved.

As one of the principal authors of the Sarbanes-Oxley Act, I support an independent accounting standard setter. However, an independent accounting standard setter has to live up to a very high standard. With respect to FASB's oversight of small business concerns, I believe that there is still a significant way to go.

Finally, I should mention that in today's Wall Street Journal there is an account of Chairman Herz conducting a conference call with institutional investors yesterday. In that call, he urges the institutional investors "to make your views known to the people in Washington" so that FASB can go forward with its proposal by the end of the year. This is further evidence that Chairman Herz will by-pass the due process for small business in order to impose his will upon process. I would like to introduce this article into the hearing record.

Interestingly, Chairman Herz's call was with institutional investors. Recent news articles have shown that institutional investors, including public pension funds, readily invest in hedge funds. I find it extremely troubling that institutional and pension fund managers will invest in unregulated hedge funds but cannot interpret the stock option information currently available in the extremely detailed footnotes of registered publicly traded companies.

In addition, I also would like to introduce a very recent study on the use of stock options into the record. The study by Professors Joseph Blasi and Douglas Kruse, found that stock options are widely held by the true workers and middle management of many companies. They are not just used by executives. As a matter of fact, a recent article in the Washington Post detailed that with or without stock options, executives will still receive their compensation. Therefore this proposal will hurt only small businesses and employees and their families.

Thank you very much for allowing me to testify today.

U.S. Senate Committee on Governmental Affairs
Subcommittee on Financial Management,
the Budget, and International Security
HEARING
"Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board"
Tuesday, April 20, 2004

Testimony of United States Senator Barbara Boxer

Thank you, Mr. Chairman, for allowing me to testify at this hearing today.

I have worked for years with Senator Enzi, Senator Ensign, Senator Lieberman, Senator Allen, and others to ensure that our colleagues are aware of the benefits for workers and our economy of broad-based stock option plans.

In June 2002, the Women's High Tech Coalition wrote to me to share their experience of what stock options have meant to women in the tech industry. I invited them to Washington to share those stories with our colleagues.

As a result of my work with them and discussions with workers all over California, I passionately believe that broad-based stock option programs are good for workers.

But, as you all know, the Financial Accounting Standards Board (FASB) has published a proposal to force companies to expense stock options, and the rule will be implemented early next year if we do nothing.

FASB continues to ignore the consequences this decision will have on rank and file employees, on our innovative technology sector, and on our economy as a whole.

Here is a sample of what my constituents are saying:

- Bill Griffin, who works for Autodesk in Palo Alto, wrote to the FASB, "Stock options are the last bastion of the hard working middle manager. For two years, the only thing that has helped me pay for two kids in college has been stock options. Without stock options, mortgaging my home would have been my only option."

- David Dorr, from San Jose, wrote to the FASB, " In my opinion, stock option compensation at Silicon Valley companies is what helped form this valley in the first place. Don't destroy it because some companies abused it by only giving options to their top executives."

- And listen to what Kelly Simmons wrote to the FASB, "If you eliminate broad based employee stock options from hard working individual contributors like me, you are taking away more than you think. You are taking away the dream of someday owning a home here in the Silicon Valley."

FASB received many letters just like these. But the FASB has made clear that it will not consider the economic consequences of its decisions.

That is why Congress must step in. Accountants are important and I have a great deal of respect for them. But in this case, they have blinders on – blinders that seemingly make it impossible for them to see the real impact of their rules change.

Let's be clear – the mandatory expensing of stock options will have the practical effect of harming – perhaps fatally – any start-up company or business plan that currently offers stock-options company wide.

As an alternative to the FASB approach, Senator Ensign and I have worked with Senators Enzi and Reid and others on legislation that would mandate the expensing of stock options for the top 5 executives at a company, but not for options granted to rank and file workers. Start-up companies would also be exempt from this bill.

In addition, the bill would require a full assessment of the costs and benefits of the expensing of all stock options before the SEC could enforce any new FASB rule on stock options.

Our bill recognizes that stock options play an important role in encouraging entrepreneurs to take the risk of starting up new, innovative firms. It allows companies to share the wealth they create with their workers. And, it sends a clear message that FASB must be fair.

Requiring the expensing of all stock options will not prevent high-profile corporate scandals. All it will do is result in rank and file workers losing their stock options.

We have a strong, bipartisan group of Senators supporting this bill and I urge the Senate to pass it as an alternative to the draconian solution FASB proposes.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses. Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002, is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises.

Like investors and creditors, Congress and other policy makers need an independent FASB to maintain and improve the integrity of accounting standards in order to obtain the financial information necessary to properly assess and implement the public policies that you favor. While current efforts by certain parties to block improvements to the accounting for equity-based compensation may seem attractive to some in the short run, in the long run biased accounting standards are harmful to investors, creditors, the capital markets, and the US economy.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all interested parties. The Board must balance the often conflicting perspectives of various parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of sound, fair, and transparent financial reporting.

On March 31, 2004, the Board issued a proposal for public comment to improve the accounting for equity-based compensation. That proposal was the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, consultation with our advisory councils, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of financial reports, and valuation and compensation experts, and active deliberations at 38 public Board meetings at which the provisions of the proposal were carefully developed with consideration given to the ongoing input received from all interested parties.

The Board believes the proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including eliminating the existing exception for so-called fixed plan employee stock options, which are the only form of equity-based compensation that is not currently required to be reported as an expense in financial statements. The proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such, and that the existing exception for fixed plan employee stock options results in reporting that ignores the economic substance of those transactions. It is important to note that when enterprises use stock options and similar instruments such as stock purchase warrants for purposes other than compensating employees, for example to acquire goods and services or in financing transactions, they have long been required to value those instruments and properly account for them in the financial statements.

Eliminating the fixed plan employee stock option exception is also responsive to the demands and concerns expressed by individual and institutional investors, pension funds, creditors, financial analysts, the major accounting firms, and many other parties. It will provide greater transparency and consistency in the reporting of various forms of equity-based compensation. It also will provide greater comparability between enterprises that compensate their employees in different ways and between the nearly 500 enterprises that have voluntarily chosen to account for the cost of all of their employee stock options and the many others that have elected not to do so.

The proposal also has the secondary benefit of achieving greater international comparability in the area of accounting for equity-based compensation. International convergence of accounting standards in this important area improves the transparency of financial information around the globe, lowering the costs of domestic and international investors, creditors, enterprises, auditors, and regulators. In that regard, our international counterpart, the International Accounting Standards Board, issued a final standard in February of this year requiring the expensing of all equity-based compensation. The IASB standard will be followed by enterprises in over 90 countries beginning next year.

Our proposal includes a Notice for Recipients ("Notice") that highlights and describes over twenty specific issues that respondents might wish to consider in developing their comments to the Board. The Notice includes several issues focusing on the proposal's measurement approach and the special provisions in the proposal applicable to small business.

The Board plans to hold public roundtable meetings with interested users, auditors, and preparers of financial reports, and valuation and compensation experts, to discuss the issues raised by the proposal. The Board also plans to discuss the views of interested parties representing small and medium-sized businesses at the inaugural public meeting of our Small Business Advisory Committee.

Following the end of the comment period on June 30th, the Board plans to redeliberate, at public meetings, the issues raised in response to the proposal. Those redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal and will include careful consideration of the ongoing input received from all parties.

Only after carefully evaluating the input at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.

I would like to conclude my statement by noting that we all have witnessed the devastating effects and loss of investor confidence in financial information that have resulted, at least in part, from companies intentionally violating or manipulating accounting requirements. Investors, creditors, and other consumers of financial reports are continuing to demand improvements in accounting and financial reporting. The existing accounting for equity-based compensation has been an area of great concern for years, and our proposal is intended to be responsive to that concern.

Let me assure you, Mr. Chairman, Ranking Member Akaka, and Members of this Subcommittee, that you, and investors, creditors, and other consumers of financial reports can have confidence that the FASB will resolve the concerns raised about the accounting for equity-based compensation in an open, thorough, and objective manner that will serve the interests of consumers of financial reports and, thus, assist in the strengthening of our capital markets and the US economy.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

STATEMENT OF PAUL A. VOLCKER
BEFORE THE
SENATE GOVERNMENTAL AFFAIRS SUBCOMMITTEE ON
FINANCIAL MANAGEMENT, THE BUDGET AND INTERNATIONAL SECURITY
WASHINGTON DC -- APRIL 20, 2004

Mr. Chairman and Members of the Committee

I have been asked to appear here today because of my responsibilities as Chairman of the Trustees of the International Accounting Standards Committee Foundation. We Trustees are charged with oversight responsibilities and appointing members of the International Accounting Standards Board (IASB), the counterpart of the US FASB.

The essential point of the IASC Foundation is to encourage common "high quality" accounting standards right around the world. Success will require a high degree of convergence between the US GAAP and international standards. Efforts to achieve that result -- hopefully in time full commonality -- are well underway.

One known obstacle to that end has become even more evident in recent months. We are not dealing simply with "technical" or "professional" issues, difficult as they are. Accounting standards need to be sensitive to legitimate business needs and practices. Both the FASB and the IASB have elaborate consultative and "due process" practices to understand and help resolve practical operational questions. It is impossible, however, to satisfy the perceived particular preferences and interests of every business, or of groups of businesses, and retain any hope of accounting consistency and discipline.

As members of Congress are well aware, that simple truth does not discourage businesses that perceive adverse consequences of a proposed accounting standard from appealing decisions to political authorities. Significantly, that has been the case in both Europe and the United States in recent months. Some European banks and insurance companies have been vigorously protesting portions of two important international standards, IAS 32 and IAS 39, that, pending European Union approval, will become binding law throughout the Union next year. Similar standards that have required accounting for financial instruments (included derivatives) are already an accepted part of US GAAP, so European approval would be a key step toward achieving convergence.

At the same time, some US businesses are vigorously urging you in the Congress to prevent, by law, expensing of employee stock options, as FASB now proposes. Such a requirement is already agreed by the IASB, and will in all likelihood be accepted and enforced in the European Union and many other countries next year. Failure of FASB to adopt a similar approach will inevitably set back the work toward convergence.

We thus have a clear illustration, on both sides of the Atlantic, of why so much emphasis has been placed on the need for professional independence in the decision-making processes of both FASB and IASB. Plainly, sheer political pressures in a national context will not, and cannot, lead to either consistency or quality. The net result of politicized national decisions would be to weaken, perhaps irreparably, one of the foundation stones of effective accounting practices in a rapidly globalizing world economy.

Every company operating internationally, investors and analysts generally, and regulators and governments, share strong interest in common accounting standards in major countries. In addition to the European Union itself, most other countries have signaled their intent to adopt international standards. But piecemeal rejection of key standards -- like IAS 39 in Europe or expensing employee stock options in the United States -- would clearly erode the basic purpose of creating a "level playing field", confusing and fragmenting markets and investors.

There is a broad area of agreement among accountants and others that employee stock options are an expense and should be so recorded in financial statements. I also recognize there has been controversy and uncertainty as to how to measure that expense with reasonable precision and consistency.

The logic of both the US and international approach is to delegate that difficult decision to the professional standard setters. As a Trustee of the IASC Foundation, it is the responsibility of my colleagues and me to ensure that the decision of the IASB is taken with due care, only after extensive consultation, and using the Board's best professional judgment. The Board itself, I should emphasize, includes not only professional accountants but also persons experienced in the practical work of preparing and analyzing financial reports.

I trust that legislators and other policy-makers both in the United States and Europe will respect that carefully conceived process. To do otherwise will surely undercut all that is being achieved toward convergence in accounting standards around the world, a key ingredient of a well functioning system of international finance.

I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:

"Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?"

"Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet the need, in a world of globalized finance, for a common set of international accounting standards?"

Written Statement of Jack T. Ciesielski

President, R.G. Associates, Inc.

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I am Jack Ciesielski, president of R. G. Associates. It is my pleasure to be participating in this hearing. The following is my written statement, which respectfully request to be entered into the public record.

First, allow me to present a brief description of my business and how it relates to this hearing. My firm, R.G. Associates, Inc. is primarily an independent investment research firm, and is dedicated to the analysis of corporate accounting issues. We have a small asset management business, but our main focus is the publication of a research service entitled The Analyst's Accounting Observer, which analyzes and explains accounting trends to both buy-side and sell-side analysts. Frequently, Observer reports are devoted to new or pending pronouncements of the Financial Accounting Standards Board. Our client base of approximately 70 firms is diverse: readers of our research range from some of the world's largest mutual fund families and well-established brokerage firms and ratings agencies, all the way down to money management firms with only a handful of employees and assets under management. In short, our client base is a unique cross-sectional view of many different kinds of financial statement users.

I've been writing the Observer for over 12 years, and as I've composed reports about new FASB standards, I've had plenty of interaction with the Board and its staff. I've participated in the Board's hearings and roundtables on proposed standards, and as a member of the Financial Accounting Standards Advisory Council and Emerging Issues Task Force, I've had ample opportunity to observe the deliberations and the due process that goes into the development of the FASB's standards. I've had the chance to see how the standard setting process benefits from the inputs provided by accounting firms and financial statement preparers - from people who are close to the issues being considered by the Board, and whose experience with those issues helps the Board develop more durable standards. In my view, the FASB's system of listening, learning, and then improving their proposals works very well as it exists.

With that, I'd like to turn my attention to the purpose of this hearing. On the surface, this hearing is all about an accounting standard dealing with stock options given to employees, but there is a much larger issue that merits our attention. That issue is the independence of the FASB. For if there were not attempts by some parties to legislate action that robs the FASB of its independence, we wouldn't be having this hearing.

The FASB plays a unique and indispensable function in our country's capital market system - as is the role of any standard setter. Progress in society would be impossible if there were not uniform standards for many of the things we take for granted: for instance, something as simple as the design of electrical outlets. That's what makes the FASB's role critical: by being the independent arbiter of principles at the foundation of financial reporting, investors benefit from financial information that is more comparable and robust than would exist if every preparer had their own way of presenting information.

In my years of observing the standard setting process, I've seen the Board develop improved accounting standards with an unmatched level of openness and fairness. Their standards will not make everyone happy - in addressing the complicated issues they're charged with, it's impossible to satisfy all parties involved. The reason we're here is because some of the FASB's constituents are so unhappy with their attempts to reform the accounting for option compensation that they've pulled Congress into the process. They're seeking a legislative answer to an accounting rule they oppose, and in doing so, usurping the FASB's authority to set standards. I believe that the FASB's ability to develop impartial standards resulting in robust information for investors to use would be seriously hampered if legislative intervention becomes the norm for disagreeing with their pronouncements, and a blueprint for such behavior was created the last time the Board attempted to remedy option compensation accounting ten years ago. While it may benefit a few of the Board's constituents to preserve the present broken accounting model, in the long run our capital markets would likely suffer - and result in capital being misallocated in the economy.

I'd like to focus the remainder of my remarks more specifically on the accounting issue under consideration, arguably the most contentious project ever taken up by the FASB. Despite the claims of vocal opponents, I do not view the FASB's proposal for equity-based compensation accounting as somehow "dangerous" or reckless. In my judgment, the Board has listened fairly to the views of its constituents and learned much as this project has wended its way from an "invitation to comment" document in 2003 to the exposure draft of a standard at the end of March.

I believe that the issuance of a final standard requiring the recognition of stock option compensation would significantly benefit the users of financial statements. I believe the argument that options cannot be valued, and therefore should reflect no compensation expense when given to employees, is without merit. Companies use option pricing models such as the Black-Scholes model to value illiquid options and warrants they hold in their corporate portfolios; they use them to value options on their stock given as consideration in making acquisitions. Yet they will claim that the same models cannot be used to value options given to employees as compensation. It seems that the only acceptable value such options can have is zero. (See Exhibits A and B).

Some of the opponents of the FASB's proposals claim that option compensation information should be relegated to a footnote as it is currently displayed. I disagree. The current presentation is a substitution of disclosure in place of proper accounting. It resulted from a Board that was badly compromised in 1994 due to the political actions that interfered with its independence. The information reported in the footnotes since 1996 were real transactions that occurred with employees, and financial statements are supposed to contain the transactions that occurred in a firm for a given period. By our count for the S&P 500, net earnings were overstated by more than $175 billion from 1995 to 2002. (See Exhibit C.) That's information about transactions which was presented only once a year to investors, rather than as it occurred each quarter - and it directly related to the resources under the firm's disposal, which management is supposed to employ for the benefit of its shareholders. That's one of the tenets of capitalism, and one that has been ignored when it comes to reporting equity-based compensation.

Opponents of the FASB proposal often claim that stock prices will fall if options compensation is recognized in earnings. I cannot think of a more patronizing argument. Markets are supposed to allow capital to flow to wherever it can earn the best return; information about how capital is being managed allows capital providers to make investment decisions. If stock prices fall because capital is not being allocated properly in certain firms, then markets are allowing capitalism to function as it should. For decades, accounting standards have done a poor job in depicting how capital is being used when it comes to equity-based compensation - and consequently, we have seen how capital has sometimes been misallocated.

The interference surrounding the FASB's equity-based compensation project is very much like a decade ago when the Board proposed that health care benefits promised to employees be accrued on balance sheets as a liability. At the time, only rudimentary information about the payments for such obligations appeared in the back pages of financial reports. Many feared that the new accounting standard would virtually bankrupt many concerns. As it turns out, the new accounting didn't bankrupt anyone - as if accounting standards have the power to add or detract from wealth. All that accounting standards can do is provide measurement, and that is where their power lies. Simply put, we manage what we measure. Once their health care liabilities were measured, American firms began managing them. I think that most would agree that the world didn't come to an end when accountants measured these liabilities - or when managers actually paid attention to the consequences of promises they had made to employees. As a nation, I think we're better off for having faced the issue - and proper accounting, not "out of sight, out of mind" disclosures - helped us face the issue.

Earlier in my comments, I mentioned that I encounter a large variety of financial statement users in writing The Analyst's Accounting Observer. There's one question about the FASB project I encounter more often than any other in my conversations with analysts of all stripes, and it isn't "Can we stop this from happening?" The question I hear most often is "When will this go into effect? We want to start adjusting our models." Investors and analysts are ready now for such information and would like to roll back the uncertainty that surrounds the way it will affect them as they do their jobs. That uncertainty will diminish once the FASB completes its project.

In closing, I would like to reiterate my support for an independent FASB to bring this project to a timely conclusion with the accounting they have proposed.

Thank you, Mr. Chairman. I would be happy to respond to any questions you may have.

Exhibit A. Financial Statement Excerpts: Firms Use of Black-Scholes Option Pricing Models to Value Options Held or Issued (other than in compensation situations)

Intel 2003 10-K (page 57)

Fair Values of Financial Instruments
Fair values of cash equivalents approximate cost due to the short period of time to maturity. Fair values of short-term investments, trading assets, long-term investments, marketable strategic equity securities, certain non-marketable investments, short-term debt, long-term debt, swaps, currency forward contracts, equity options and warrants are based on quoted market prices or pricing models using current market rates. Debt securities are generally valued using discounted cash flows in a yield-curve model based on LIBOR. *Equity options and warrants are priced using a Black-Scholes option pricing model.* For the company's portfolio of non-marketable equity securities, management believes that the carrying value of the portfolio approximates the fair value at December 27, 2003 and December 28, 2002. This estimate takes into account the decline of the equity and venture capital markets over the last few years, the impairment analyses performed and the impairments recorded during 2003 and 2002. All of the estimated fair values are management's estimates; however, when there is no readily available market, the estimated fair values may not necessarily represent the amounts that could be realized in a current transaction, and these fair values could change significantly.

Apple Computer 2002 10-K (page 79-80)

Acquisition of PowerSchool, Inc.
In May 2001, the Company acquired PowerSchool, Inc. (PowerSchool), a provider of web-based student information systems for K-12 schools and districts that enable schools to record, access, report, and manage their student data and performance in real-time, and gives parents real-time web access to track their children's progress. The consolidated financial statements include the operating results of PowerSchool from the date of acquisition.

The purchase price of approximately $66.1 million consisted of the issuance of approximately 2.4 million shares of the Company's common stock with a fair value of $61.2 million, the issuance of stock options with a fair value of $4.5 million, and $300,000 of direct transaction costs. *The fair value of the common stock options issued was determined using a Black-Scholes option pricing model* with the following assumptions: volatility of 67%, expected life of 4 years, dividend rate of 0%, and risk-free rate of 4.73%.

Total consideration was allocated as follows (in millions):

Net tangible assets acquired	$ 0.2
Deferred stock compensation	12.8
Identifiable intangible assets	2.6
In-process research and development	10.8
Goodwill	39.7

Total consideration	$ 66.1

Critical Path 2003 10-K (page 42)

Acquisitions

Using the Black-Scholes option-pricing model and assuming a term of 7 years and expected volatility of 90%, the initial fair value of all the warrants on the effective date of the agreement approximated $26.4 million, which is included as a component of the purchase price of the acquisition.

Exhibit B. Barron's Editorial

Reprinted from BARRON'S

May 5, 2003

EDITORIAL COMMENTARY

JACK T. CIESIELSKI

Another Options War

The political defense of stock options threatens accounting standards

Mark Twain said that history doesn't repeat itself, but it rhymes. For example, 12 years after the 1991 Gulf War, there's the current Iraqi conflict. History is rhyming faster when it comes to another war of the 1990s. The first stock-options war took place in 1994—the second is going on right now. The first stock-options war left the Financial Accounting Standards Board badly beaten. Having called for compensation expense paid in stock options to be recognized in earnings, the FASB was maneuvered into a compromise requiring companies merely to make annual disclosures of what they should have been reporting in earnings.

The weapon that won the war for Silicon Valley and its allies was political hot-air power rained on the FASB and the Securities and Exchange Commission. Senator Joseph Lieberman, the Connecticut Democrat who now is running for President, proposed to put every movement of the FASB under the thumb of the SEC, fully aware that the SEC is easily influenced by Congress—as no less than former Chairman Arthur Levitt confessed in his recent book.

Lieberman in effect was proposing the federalization of the independent accounting standard-setting process. Compared to a blunder of that magnitude, stock-option accounting was trivial. The SEC and the FASB surrendered.

Smart Bomb

The weapons of air power have been refined in the last nine years; fewer Iraqis died and victory was more complete. In the stock-options war, a new weapon of hot-air combat is also somewhat smarter. The new political weapon is a bill named for Reps. David Dreier and Anna Eshoo, Republican of California and Democrat of California, respectively. It would prohibit the SEC from recognizing as Generally Accepted Accounting Principles any new accounting standards related to the treatment of stock options for at least three years. That's an effective moratorium on anything FASB develops in its current option accounting project.

Like a smart bomb, the bill is a bit more targeted than Lieberman's 1994 blockbuster, but the result is no different. It would put the independent FASB under the purview of the SEC so Congress can force the commission to provide the answers members like for their lobbying constituents.

Doing her part, Senator Barbara Boxer, the California Democrat, is working on the Senate version of the Dreier-Eshoo bill and she promises that her version "will send this whole matter to the SEC for review before the proposed rule goes into place and we are dealing with its unintended negative economic consequences."

It's not the unintended consequences that she and Silicon Valley friends are worried about. It's the fully intended consequences, such as less-inflated earnings reports, better-justified executive compensation and reduced corporate obsession with the vagaries of the stock market.

The eagerness of lawmakers to work with Silicon Valley executives on legislation to control accounting standard-setting is a frightening sight to behold; it provides more evidence of the need for standard-setting that's out of their direct political grasp. An independent FASB is the best hope of America's individual investors, who don't have a well-oiled lobbying machine and aren't well-represented by elected officials.

Math Phobia

Another Silicon Valley weapon that has been refined in the last nine years is the anti-Black-Scholes missile, aimed at the well-known if poorly understood option-pricing model. Call it a weapon of mass distraction. Rather than attempt to refute the inconvenient fact that an option represents something given to an employee in return for service, the opponents of option expensing muddy the issue by claiming that the accounting doesn't work. They invoke math phobia related to the Black-Scholes model's complex formula. A recent Wall Street Journal opinion piece by Intel's chief executive officer derided its use in valuing employee stock options, claiming that it produces "results that are inherently inaccurate and unreliable for this purpose" and that the model is "unworkable."

JACK T. CIESIELSKI writes The Analyst's Accounting Observer, a newsletter, and manages investments in Baltimore. He is a member of the FASB Emerging Issues Task Force, but the views expressed here are his own.

(over please)

Intel's own financial statements, however, say that when it comes to determining the fair value of equity options and warrants, Intel uses a Black-Scholes option pricing model. (Incidentally, warrants have longer lives than the Black-Scholes model was designed to handle—just like employee stock options.) How can the model be "inherently inaccurate and unreliable" and "unworkable" when applied to employee stock options, yet perfectly fine when valuing financial instruments held by the company as assets? If they despise the Black-Scholes model when it comes to employee stock options, why hail its validity for valuing similar instruments appearing elsewhere in the financials?

Intel isn't alone in its utter hypocrisy Other critics of option expensing are guilty of the same contradiction In a 2001 acquisition, Apple Computer issued stock options—with a four-year life, same as for its employee stock options—as part of the consideration given to the shareholders of the acquired company, and valued them using a Black-Scholes option-pricing model. In the same year, Medtronic capitalized the cost of employee stock options exchanged in an acquisition—and in recording the acquisition, valued them using the Black-Scholes model. Palm issued a five-year warrant to a customer in 2001, and valued it with the Black-Scholes model And QLogic issued warrants to customer Sun Microsystems, valued by—you guessed it—the Black-Scholes option-pricing model Accounting standards governing those transactions did not require the use of that much-demonized mathematical formula; firms have latitude in choosing the methodology used to estimate fair values.

How come the Black-Scholes model is acceptable for recording other option values when it's unacceptable for employee compensation options? The answer is clear. When you do option math in Silicon Valley, the only suitable value an option can have at the time it's given to an employee is "zero."

But stock options are compensation. Employees are happier when they have them. (If you want to make employees unhappy, just try taking them away.) Options give an employee the right to buy shares of stock at a fixed price for, usually, the next ten years—a pretty powerful economic benefit. Wouldn't you like to be able to lock in the price of a car, a house, or a college education for a decade? Would you expect to get that right—that option—for free? Well, maybe if you're a technology company executive, but the rest of us who live in a more rational economic world know there's a price to pay for that right.

A stock option's minimum value should be the current stock price discounted by the risk-free rate over the option term, less the present value of dividends foregone, if any, by holding an option instead of stock That boils down to the option's time value. If companies had a genuine interest in developing reasonable values for option compensation, they might propose solutions to the valuation problem starting with this fundamental financial premise—but because the minimum value won't equal zero, they continue to present absurd quasi-metaphysical reasons as to why options "can't be valued." Or even more bizarrely, they contend that options are "already accounted for."

Dire Consequences

Maybe history isn't rhyming this time; maybe the outcome of this stock-options war will be different. The market and the economy certainly provide a different backdrop this time. Obviously, Enron changed a lot of investor perceptions—and even a few political minds—about the importance of honest accounting.

Self-righteous Silicon Valley types whine that by recognizing the cost of option compensation, they're being made to suffer for the sins of Enron, Global Crossing, WorldCom and so on. That's a misplaced argument. Whether the cost of option compensation is fair is for the owners of companies to decide, and they must realize that they need to see the cost first.

The FASB's 1994 defeat couldn't have happened without the apathy of investors. Neither institutional nor individual investors supported the FASB much in its quest to end dysfunctional accounting for stock- option compensation. If history is to be kept from rhyming, both kinds of investors must make their voices heard at the FASB and in Congress ■

Addition to Written Statement of
Jack T. Ciesielski
President, R.G. Associates, Inc.

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I appreciated the opportunity to serve as a witness at the hearing yesterday afternoon, and would like to add to my written statement. There were a number of issues that I did not have the opportunity to comment upon; I would like to do so now. I respectfully submit this document to be entered into the public record.

I am deeply troubled by Senator Enzi's assertion that the proposed FASB standard on equity-based compensation imposes great costs on small businesses. I have a hard time seeing just how this could be true. The vast majority of small, privately-held businesses - the kind that Senator Enzi claims will be somehow harmed by this pronouncement - should be totally unaffected by this pronouncement for the simple fact that they do not usually issue stock options. There may be facts available from the Bureau of Labor Statistics that bear this out; but in my experience, stock option plans simply do not exist in these kinds of firms.

It is possible there are very large privately-held companies that issue options to employees - the kinds of businesses taken private by leveraged buyout firms with the intention of eventually bringing the companies back to public ownership. Conceivably, these firms would be affected by the proposed accounting rule - but these firms would also likely possess a degree of scale and sophistication such that the new accounting would present no great hurdle.

Senator Enzi is concerned that the FASB has not sought the input of these "affected constituents," for instance, in the planned roundtables. For the reasons just stated, I believe his concern is misplaced. The privately-held firms he champions are just not affected by this proposal.

Senator Bennett stated that an option with a thirty-year life has zero value today. This simply cannot be so. The right to buy anything at a fixed price for thirty years is very valuable. In the case of stock options, people want them because they expect the price of the underlying stock to increase. Nobody wants to hold stock options because they expect the price of the stock to decline. So - a thirty-year option to buy stock at current prices would be a very valuable item indeed.

Senator Bennett also gave an example to FASB Chairman Robert Herz contrasting an option that vests today with one that vests in ten years; he claimed they would have the same value under the FASB proposal. Again, this cannot be so. The expected life of the two options would be radically different; the one that vests tomorrow might be exercised tomorrow, and the one that vests in ten years couldn't be exercised for at least ten years. The expected life of an options has a direct bearing on its value, so there is no possible way the two different options could have the same value today. Any point being made was based on a misinterpretation of the proposal. I believe Chairman Herz interpreted the Senator's example as a question of how the expense would be recognized over time. I am not sure that there was a genuine meeting of the minds.

There were numerous assertions that the valuation methods required by the FASB model attempts to predict the successful exercise of options; in fact, I believe one of the subcommittee members asked if studies had ever been performed to validate the effectiveness of the Black-Scholes or lattice models in such predictions. This is a grave misunderstanding of the fundamental purpose of such valuation models. The objective is to estimate what such options are worth today, not whether they will be exercised. If a firm is going to issue illiquid options or warrants in a private placement with, say, an institutional investor, they would estimate their fair value in order to assure themselves that they are not selling them too cheaply. They - or their investment bankers - would be quite likely to use one of these models to estimate what such instruments should fetch, before bargaining with the potential buyer. It is this estimated value of the options - what the instrument would sell for today - that represents the compensation being earned over the period the employee provides service.

I find it contradictory that firms claim such models can't be relied upon for estimating the value of options given to employees - yet they use such models in valuing securities in their own corporate portfolios. I present from page 57 of the 2003 Intel Corporation 10-K (emphasis added):

> Fair values of cash equivalents approximate cost due to the short period of time to maturity. Fair values of short-term investments, trading assets, long-term investments, marketable strategic equity securities, certain non-marketable investments, short-term debt, long-term debt, swaps, currency forward contracts, equity options and warrants are based on quoted market prices or pricing models using current market rates. Debt securities are generally valued using discounted cash flows in a yield-curve model based on LIBOR. *Equity options and warrants are priced using a Black-Scholes option pricing model. For the company's portfolio of non-marketable equity securities, management believes that the carrying value of the portfolio approximates the fair value* at December 27, 2003 and December 28, 2002. This estimate takes into account the decline of the equity and venture capital markets over the last few years, the impairment analyses performed and the impairments recorded during 2003 and 2002.

There are instances when firms use such models to value options given in consideration for business combinations. I quote from pages 79-80 of the **Apple Computer** 2002 10-K (again, emphasis added):

> **Acquisition of PowerSchool, Inc.**
>
> In May 2001, the Company acquired PowerSchool, Inc. (PowerSchool), a provider of web-based student information systems for K-12 schools and districts that enable schools to record, access, report, and manage their student data and performance in real-time, and gives parents real-time web access to track their children's progress. The consolidated financial statements include the operating results of PowerSchool from the date of acquisition.
>
> The purchase price of approximately \$66.1 million consisted of the issuance of approximately 2.4 million shares of the Company's common stock with a fair value of \$61.2 million, the issuance of stock options with a fair value of \$4.5 million, and \$300,000 of direct transaction costs. *The fair value of the common stock options issued was determined using a Black-Scholes option pricing model* with the following assumptions: volatility of 67%, expected life of 4 years, dividend rate of 0%, and risk-free rate of 4.73%.
>
> Total consideration was allocated as follows (in millions):

Net tangible assets acquired	$ 0.2
Deferred stock compensation	12.8
Identifiable intangible assets	2.6
In-process research and development	10.8
Goodwill	39.7
Total consideration	$ 66.1

Are these firms trying to predict the future exercise of stock options? Certainly not. They are using models to estimate the value of a holding (Intel) or consideration given (Apple). Options are given to employees as consideration for services they will provide the firm. Firms can estimate the value - they've demonstrated they can. They simply don't want to acknowledge that they are providing compensation in this fashion.

Another frequent misconception that needs to be clarified. There were panel members and committee members who asserted that this pronouncement would prohibit the issuance of stock options. There is no truth to this statement. The pronouncement would only address the accounting for stock options. Though it is apparently viewed as all-powerful, even the FASB cannot issue a standard that would bar the creation of certain types of financial instruments. Firms might be more careful about the level of shareholder resources they devote to such instruments once they account for them - but this is not a prohibition brought about by an accounting standard.

Mr. Delves made a point that I believe was severely overlooked, and it can be reduced to this statement: we manage what we measure. Option compensation has not been measured effectively, therefore it cannot be managed effectively. The FASB proposal provides a method for effective measurement, and provides markets with the chance to monitor the stewardship of shareholder resources. That leads me to the final point I wish to make. Much was made of the effects of recognizing option compensation on earnings, that the recognition of such expense would bring about the destruction of shareholder wealth. This was an assertion about stock prices made with great certainty - and I believe that it was made by the same parties asserting that option values cannot be determined. It seems rather contradictory to me that some folks "know" stock prices will decline if option compensation expense is recognized in financial statements - but the same folks say stock options cannot be valued - and stock options derive their value from stock prices.

The truth is, nobody can say for sure what stock prices will do if option compensation is recognized. Nobody can say for sure what happens when *any* new accounting standard brings new information to the markets. There's been a decidedly negative take on this by the opponents of the FASB proposal, naturally. It's entirely possible that well-designed stock option plans that are transparent to market participants might even be very well-received by the market. So far, there's no apparent evidence that any of the hundreds of companies that have adopted a policy of option expense recognition have seen their stock price harmed because of this choice.

Once again, I would like to reiterate my support for an independent FASB to bring this project to a timely conclusion with the accounting they have proposed. I would be happy to respond to any additional questions you may have.

Testimony of

Donald P. Delves
President
The Delves Group

Introduction

Mr. Chairman, members of the Committee, and distinguished guests, thank you for inviting me to speak with you today regarding this important issue.

My name is Don Delves. I am the President of The Delves Group, a Chicago-based consulting firm specializing in corporate governance and executive compensation.

Stock option expensing is truly one of the most pressing issues facing Corporate America today. Because the FASB has finally started to address the critical issue of stock option expensing in a meaningful way, long overdue change is happening in boardrooms across the country. In order for this process to continue, and in order to promote healthy executive compensation and higher levels of accountability to shareholders, it is critical that the FASB remain fully independent of the political process. The FASB and the business community must be free to debate this issue and determine the best possible outcome for the benefit of corporations and their shareholders.

As an expert in the compensation field with 20 years of experience, I see this issue as central to helping boards of directors hold management accountable, and to expect – and get – the best performance on behalf of the shareholders. Without stock option expensing, boards of directors have been seriously hampered in their ability to address the basic question of *how much pay for how much performance*. That fundamental capitalist equation – how much for how much – has been subverted for too long by bad accounting.

It is the board's job to marshal and allocate shareholder resources in the most effective way possible. Boards have at their disposal a very powerful tool – stock and stock options -- which they have the right and the ability to share with management and employees. Until now, however, boards of directors have not had the means to accomplish this goal in the most effective and responsible way. They have lacked a reliable way to quantify how much ownership and shareholder wealth was being given to executives and employees through stock option grants. As a consequence, boards have not effectively done their jobs of requiring commensurate performance in exchange for that ownership interest.

Working with companies and boards of directors as a compensation expert, I have been stymied in my efforts to design and implement pay-for-performance packages. The reason is simple: A bad accounting rule allowed a very narrow definition of a derivative security called an employee stock option to be granted without expense to the company. With no expense, these "free" options were liberally given out to executives and employees (although mostly to executives) with very little rigorous thought about the effect on shareholder value and future shareholder wealth.

This has had dramatic consequences for thousands of companies and boards of directors across the country. From 1994 to 2002, mainstream American companies tripled their use of stock options. In eight years, stock options exploded from 3%-5% of a company's stock on average to 13%-15%.[1] And what did we get in return? The sad answer is that we don't know – and neither do the boards of directors of America's corporations.

Also as a result of the proliferation of stock options, we have seen the dominance of one very narrowly defined form of compensation in executive pay. Not only have vast amounts of wealth been shared, with no commensurate demand for performance, it's been done in an extremely uncreative, one-size-fits-all way. Why? Because there was only one, very specific definition of stock options that allowed them to be free. The old accounting rules not only limited accountability, they almost entirely eliminated creativity in how compensation systems were designed.

The good news, however, is that because of the likelihood of the stock option expense, in boardrooms across the country companies are rethinking and redesigning their executive compensation programs. While the process is extremely healthy, some of the results are good and some are not. Many companies have made very positive moves toward requiring greater performance in exchange for valuable ownership interests. Other companies, however, have merely replaced stock options with stock grants that vest with the passage of time. Compared with stock options, this is clearly a step backwards.

The other good news is that the FASB's proposed expense for options has prompted companies to begin taking a hard look at the wealth transfer that has occurred from shareholders to executives through stock option grants. My firm has been working with

[1] Investor Responsibility Research Center (2002).

companies, and in particular with boards of directors, to help them calculate the sheer size of this wealth transfer. In many cases, the findings have been a shocking but necessary eye-opener for the board.

For example, in our work with a major corporation, my firm was able to demonstrate to the board that over a 10-year period, $1.2 billion in wealth had been transferred from shareholders to executives. Importantly, there was no readily available way that the board could have ascertained this number without our in-depth analysis. That's because it is impossible with existing financial statements to figure out how much wealth has been transferred from shareholders to executives. We had to really dig into the company's numbers to figure it out.

For the same company that had transferred $1.2 billion in wealth, we also calculated what the expense would have been over the same 10-year period using the FASB's proposed method. The result was a cumulative expense of approximately $600 million – roughly half the amount of the wealth transfer.

This is fascinating. Based on our analysis and work with a variety of companies, we believe that the FASB's proposed method will result, on average, in an expense equivalent to 50% of the wealth transferred over time.

What's interesting, though, is that while the FASB's proposed method captures half the wealth transfer over time, there is a problem here. This method requires companies to record that expense upfront regardless of what the wealth transfer ultimately will be. For some companies, the wealth transfer to executives will be very large and greater than the expense. For others, if the stock price goes down it will be less than the expense. And in some cases it could be zero.

My concern is this upfront expense could overly discourage the use of stock options. That would be too bad because stock options, if used appropriately, are a powerful incentive to increase the value of the company. Because of this, I like the FASB's alternative method that is allowed for certain non-public companies. This method, called the intrinsic value method, measures the expense over time as the stock price fluctuates.

The total expense, however, reflects the gain from the actual transaction when –and if – the executive exercises the option.

The intrinsic value method, while it may end up with a larger and more unpredictable expense, does a better job of reflecting the real cost to shareholders. So from the standpoint of good governance and effective compensation design, this method could produce better results, and more creative ways to use options and other ownership incentives.

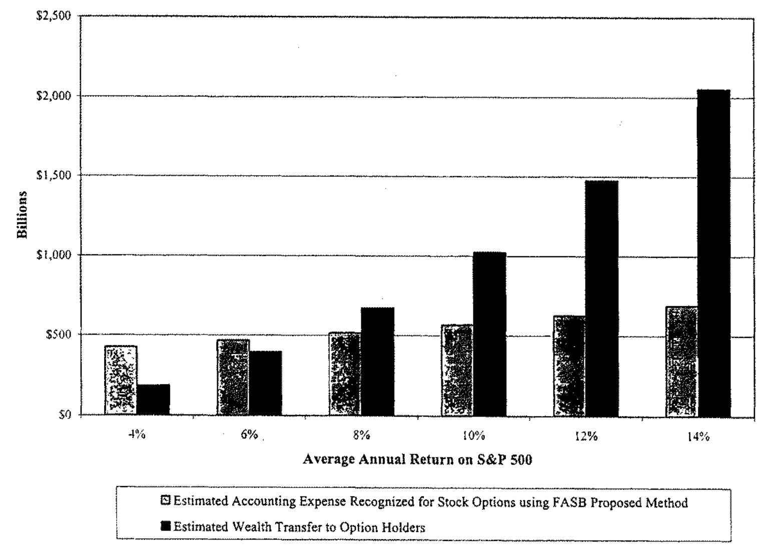
The essence of the stock option issue is integrity and accountability in corporate governance. My job is to help management and boards of directors to understand the true cost to shareholders of using these incentives and to help ensure that they are getting the highest performance possible from executives in exchange for that cost.

In summary:

- It is critical for the FASB to debate and make decisions without government intervention.
- Since the FASB last tried to introduce an expense for options 10 years ago, vast amounts of shareholder wealth have been transferred to executives with little accountability or measurement.
- An accurate and meaningful expense for options is essential for America's corporations to operate with accountability and integrity.

Exhibit A

Estimated Economic Impact of Stock Options
Over the Next Ten Years (2004 - 2013)



THE DELVES GROUP

CHICAGO CONSULTING ACTUARIES

Hearing of the Senate Government Affairs Committee

on

Oversight Hearing on Expensing Stock Options

Tuesday, April 20, 2004

Written Testimony of Mark Heesen

President, National Venture Capital Association

Mr. Chairman and Members of the Committee, good afternoon. I am Mark Heesen, president of the National Venture Capital Association (NVCA), which represents 460 venture capital firms in the United States. As you know, venture capital is the investment of equity to support the creation and development of new, growth-oriented businesses. Venture capital backed companies are critical to the U.S. economy in terms of creating jobs, generating revenue, and fostering innovation. This segment of the economy, the entrepreneurial segment, is the true differentiator for the U.S. in terms of global competitiveness. U.S. companies originally funded with venture capital now represent 11% of annual GDP and employ over 12 million Americans. These organizations include AOL, Intel, Cisco, Home Depot, Amazon, Starbucks, Genentech, and Federal Express.

I am here today on behalf of the Federal Express' of tomorrow - our country's venture backed start-up companies whose futures are being threatened by implications of the Financial Accounting Standards Board's (FASB) Exposure Draft, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95.* This proposal mandates the expensing of employee stock options. The NVCA has a long history of working with FASB on the issue of stock options and our opposition to mandatory expensing is well known. We continue to assert that the lack of a reliable valuation method to measure the "expense" of options will result in inaccurate financial statements, and will cost American companies billions of dollars in additional, unnecessary accounting and valuation fees. The proposed rule will most seriously hamper the start-up business community, which may be forced to choose between using a tool that has made our entrepreneurial activity the envy of the world or wasting significant resources to produce reports that essentially misrepresent a company's financial health.

Within the last year, the FASB has demonstrated an increasing disregard for the effects of its stock option accounting proposal on these private, emerging growth businesses. Despite countless calls from small companies to make distinctions between themselves and large, publicly traded entities, the FASB has actually regressed significantly in this area. The most recent exposure draft is a stark contrast to FASB's stance in 1994 when it issued the current rule, FAS 123, in which exceptions were made for private companies. Most assurances from FASB Chairman Robert Herz on addressing these issues have gone unmet with the one exception of the creation of a Small Business Advisory Group. Unfortunately and perhaps conveniently, this group will not begin to meet until May of this year and will certainly not be functional in time to contribute to the current debate. Other issues for privately held companies including those on valuation, the cost of compliance, and the risk to jobs at US start ups have been ignored. I would like to share with you the problems associated with these areas.

Employee stock options are a critical factor in fueling entrepreneurial innovation and economic growth. Entire industry sectors such as biotechnology, software, and microprocessors simply would not exist today without venture capital and employee stock options. Almost without exception, young, growth oriented companies use options to attract the best and brightest talent at a time when cash is scarce. These employees have the pioneering spirit that the US economy has been built upon. They take the risks to work for unproven organizations, knowing that through their stock option programs, they may be rewarded if the company becomes a success. Employee stock options foster this American entrepreneurial spirit at all levels of organization, with an estimated 14 million workers holding these incentives. Should the FASB proposal go through as is, stock options will be too costly for most young companies to grant to all employees, seriously blunting an economic tool that has given U.S companies a competitive advantage over our foreign counterparts.

One of the largest costs associated with the mandatory expensing of employee options is the cost of valuing these incentives. Despite acknowledgement from both sides of the expensing debate that no accurate model for valuing employee stock options exists, the FASB has put forth three "acceptable models" for deriving an expense number. The first, the Black Scholes model, has been widely discredited as being inaccurate for valuing employee stock options. The second, the lattice or binomial method, uses inputs similar to Black Scholes but is even more complex, asking for more assumptions by the company. Notably for start-ups, both Black Scholes and the lattice method require volatility as a critical input. Yet, the underlying shares of a privately held company have never been liquid, so there is no precedent to derive a volatility number, thus creating a significant and costly accounting quagmire. From a formulaic perspective, if one uses the "wrong" volatility, there will be a meaningful distortion of the value of the stock option. FASB is familiar with this issue. In promulgating the current stock options rules contained in Statement No. 123, FASB determined that measuring volatility for private companies was too difficult. The FASB stated:

"An emerging entity whose stock is not yet publicly traded may offer stock options to its employees. In concept, those options also should be measured at fair value at the grant date.

However, the Board recognizes that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. The Board therefore decided to permit a nonpublic entity to omit expected volatility in determining a value for its options. The result is that a nonpublic entity may use the ***minimum value*** method . . .." Basis for conclusions ¶ 174. (The minimum value method allows the volatility input to be set at zero.)

Rather than continue to offer minimum value as an option for privately held companies, FASB's new treatise neatly advises these start-ups to make a "policy choice": use the same fair value accounting as public companies (Black Scholes or lattice method) or use a third option, "intrinsic value" reporting. At first blush, the nod to intrinsic value may seem an acknowledgement by FASB of the particular valuation challenges faced by venture-backed companies. However, offering intrinsic value – as defined by FASB in its exposure draft – is akin to offering no choice at all.

FASB defines "intrinsic value" as the amount by which the fair value of an equity share exceeds the exercise price of the option. Historically, when granting options, both public and private companies set the fair value at the exercise price resulting in a "zero" intrinsic value for the options. Of critical importance, however, is that the historical intrinsic value calculation took place only once, at a single snapshot in time – the time of the options grant. Now, however, FASB has modified the intrinsic value calculation to require "that share options and similar instruments be **remeasured** at intrinsic value **at *each* reporting period** through the date of settlement."

Valuation of a private, venture-backed company's stock is a process, which at best is costly, complex, and inexact. Absent new rounds of financing, venture capitalists rarely have information upon which to base changes of the set stock price because the stock is not tradable and the companies tend to be unique, with no like comparisons to benchmark. It is this continuous and repeated recalculation of intrinsic value that results in a Sisyphean challenge for venture-backed companies, requiring a constant analysis and calculation of the underlying stock value. And, in the end, the final number will be an inaccurate, inconsistent and incomparable guess.

In addition to inaccurate financials, another serious concern is the monetary and human cost that will be required for young companies to undertake the valuation process. These organizations cannot afford the outside expertise required to work through complex valuation models nor can they afford to spend the time to do this themselves. Yet, FASB's mandate will force small companies to address these accounting issues, distracting management, raising expenses and lowering the bottom line. Implementing mandatory stock option expensing also imposes a financial reporting credibility cost that heavily impacts small companies. Public company analysts have said that they will "look through" numbers impacted by stock option expensing to a companies' underlying financials. Yet, over 50% of the NASDAQ companies and virtually ALL private companies do not have analyst coverage. Who is going to look through their numbers? By placing this accounting burden on young companies, FASB is lengthening the reliance on expensive, high risk capital to the start-up sector.

In response to these issues, Chairman Herz has remarked that for non-SEC registrants, following GAAP is a matter of choice not a requirement. However, venture-backed start-ups generally report their financials under GAAP because they do expect to one day move through an initial public offering or become acquired by a public company. Further, it is a mistake to think that all the stakeholders in venture-backed companies are sufficiently sophisticated that they can make adjustments for this non-cash expense. Private company financial statements are used by many constituencies, many of whom lack the data or sophistication to make adjustments, including customers, vendors, and employees.

NVCA understands Congress' reluctance to involve itself in the setting of accounting standards. However, private companies are in a unique situation with virtually no recourse and FASB's deadline looming. While public companies can look to the SEC for additional guidance on many issues, private companies do not fall under SEC purview and have nowhere to turn for support. We see an urgent need for checks and balances in our system at this time.

We believe The Stock Option Reform Act (S. 1890) seeks to preserve broad-based employee stock option plans and addresses the serious implications of expensing for emerging businesses. By limiting mandatory expensing to the top five executives, the Act targets executive compensation while simultaneously preserving the ability of companies to deliver option plans to rank and file workers. By exempting the expensing requirement for small businesses until three years after an initial public offering, the Act relieves the compliance burden from young companies seeking to go public and allows a company stock to settle down from the volatility of the IPO. By setting the volatility at zero for valuation purposes as allowed under current FASB rules, the Act removes a key variable that creates a highly inaccurate expense figure. Finally, by requiring the Secretaries of Commerce and Labor to complete a joint study on the economic impact of mandatory expensing, the Bill thwarts a "rush to regulate" effort by the FASB and prevents severe, unintended consequences for our economy and our international competitiveness.

Should the FASB move forward with its current stock option accounting mandate, the Board will be acting in direct conflict with its stated goals:

"The Board strives to determine that a proposed standard will fill a significant need and that **the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits** from improvements in financial reporting....The Board has long acknowledged that the **cost of any accounting requirement falls disproportionately on small entities** because of their limited accounting resources and need to rely on outside professionals." (FAS 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, basis for conclusions ¶¶ 9, 10, emphasis added.)

The inability to accurately derive volatility, and the difficulty in determining a common stock price for young private and newly public companies has not changed since the last FASB stock options pronouncement in 1994. If FASB's proposal is allowed to stand, what will change is the entrepreneurial energy that now accounts for over 10% of the U.S. economy. This energy will be drained at a time when our global competitiveness is increasingly challenged by growing economies overseas. International convergence of accounting standards such as mandatory expensing will touch the US and Europe, not China and India where accounting standards are more supportive of stock options. Today, we applaud Congressional leaders for addressing the practical impact of FASB's stock option expensing proposal. We urge the passage of The Stock Option Reform Act as it seeks to protect our country's entrepreneurial spirit while upholding the financial integrity and enhanced transparency sought by all.

Thank you for the opportunity to express NVCA's views on these vital issues.

Testimony by James K. Glassman
Resident Fellow, American Enterprise Institute

Mr. Chairman, members of the subcommittee:

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute, where much of my work focuses on financial regulatory matters and economics. I am also host of the website TechCentralStation.com, established in 2000 to address the nexus among finance, technology and public policy. Since 1993, I have written a syndicated financial column for the Washington Post that seeks to inform small investors. I am also a member of the Policy Advisory Board of Intel Corp.

Today's hearing is critical. On March 31, 2004, the Financial Accounting Standards Board (FASB), a private-sector board that sets U.S. accounting rules, published an exposure draft of a proposal that would require stock options be treated as an immediate expense in financial statements of corporations.[1] The comment period for the proposal ends June 30.

FASB intends to move swiftly to implement the proposal. The immediate result of expensing will be a reduction in reported earnings for thousands of U.S. corporations. Earnings for companies that comprise the benchmark Standard & Poor's 500 Index "would have been 10.6 percent lower in 2003, 19.2 percent lower in 2002, and 21.5 percent lower in 2001 if all of the member companies had treated options as an expense."[2]

One result, which we may already be seeing, is lower stock prices than would otherwise obtain. Another result, as many corporate managers have already stated, is that, if the FASB proposal is enacted, companies will discontinue or reduce options programs, which have provided important incentives for employees well below the top management level. Discontinuing or reducing options programs will have an adverse effect on U.S. competitiveness, innovation and jobs.

It is my view, as this testimony will show, that mandated expensing of stock options is a serious mistake. The current regime -- which allows companies to choose whether to expense options immediately or to provide extensive disclosures and record the dilutive

[1] Financial Accounting Standards Board, *Exposure Draft, Proposed Statement of Financial Accounting Standards, Share-Based Payment: An Amendment of FASB Statements No. 123 and 95*, March 31, 2004, p. i.

[2] "Congressman Disappointed in FASB, Sets Hearing," Phil McCarty, Wall Street Journal Online, April 1, 2004.

effects of options on earnings per share – is a far better approach. I also believe strongly that Congressional and executive-branch policymakers have the responsibility to exercise their own judgment in the matter of options expensing. The issue is far too important to be decided alone by an accounting board in Norwalk, Conn.

The purpose of this hearing is: 1) to explore "the importance of FASB's independence," 2) to "evaluate its proposal for mandatory expensing of stock options" and 3) to "determine the economic and accounting/financial reporting impact" of the proposal.[3] Let me take each of these three items in turn. First, however, some background is in order.

Background

An option is literally a choice. The owner of a fixed employee stock option typically has the choice of purchasing shares at a fixed time in the future at a price that was fixed at the date it was granted. Often, that price is the market price at the date of the option grant, for example, $30 per share. Employee stock options – unlike call options traded on exchanges – usually have a vesting period of around three years. If the employee is still working at the company, he or she may exercise the option by paying the company $30 per share. The employee can then either sell the stock at a profit or hold it for a longer period. It is not difficult to see how such options help align the interests of employees with those of shareholders, whose main concern is that the value of their stock increase.

Over the past 10 to 15 years, smaller businesses, as well as large, have turned to employee stock options as a reasonable means to achieve success:

"Offering stock options in lieu of cash compensation allows companies to attract highly motivated and entrepreneurial employees and also lets companies obtain employment services without (directly) expending cash. Options are typically structured so that only employees who remain with the firm can benefit from them, thus providing retention incentives.... Stock option plans give executives a greater incentive to act in the interests of shareholders by providing a direct link between realized compensation and company stock-price performance."[4]

Encouraging managers, especially, to adopt a shareholder orientation became a major concern in the 1970s when managers, who often owned little stock, were appropriately criticized for using corporate assets for their own benefit and paying scant attention to the interests of institutions and individuals who were the actual owners of their companies. By the end of the 1990s, roughly one-third of the compensation of CEOs came in the form of stock options, up from one-fifth in the 1980s.[5]

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[3] Senate Committee on Governmental Affairs, website at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=170

[4] Hall, Brian J., and Murphy, Kevin J., "The Trouble With Stock Options," *Journal of Economic Perspectives*, Summer 2003, 17:3, p. 49.

[5] Byran, S., Hwang, L., and Lilien, S., "CEO Stock-Based Compensation: An Empirical Analysis of Incentive-Intensity, Relative Mix, and Economic Determinants," *Journal of Business*, 2000, 73:4, p. 661. The authors also report, at p. 687, that "the percentage of firms with no CEO stock option awards steadily decreased from 46 percent in 1992 to 28 percent in 1997."

"Options," as two distinguished economists, William Baumol and Burton Malkiel, wrote last year, "are needed to insure compatibility of the interests of stockholders and management, whose divergence has recently been so dramatically demonstrated."[6] This principle received a boost in 1993, when tax legislation disallowed "the deductibility of compensation paid to executives that exceeds $1 million – unless that compensation is 'performance-based.' Fixed stock options are deemed performance-based compensation for tax purposes."[7]

Most holders of employee options, however, are not in upper management. A new study by Joseph Blasi and Douglas Kruse of Rutgers University and Richard Freeman, professor of economics at Harvard, found that 94 percent of options are held by employees below the top levels of management. About 13 percent of the nation's private-sector workforce holds options, including 57 percent of workers in computer services companies, 43 percent of workers in communications and 27 percent in the finance industry.[8] Another study found that options are mainly used by "New Economy" firms. The average grant-date value of options per employee of such firms was $18,882; for "Old Economy" firms, $2,856.[9] This disparity explains part of the interest of many more established firms in pushing for an options-expensing regime. Older firms may want to deny New Economy firms a powerful competitive tool.

The controversy over the accounting treatment of stock options goes back more than 30 years. In 1972, the Accounting Principles Board, predecessor to FASB, issued Opinion No. 25, which stated that no compensation expense need be recognized for fixed stock options granted to employees at the time of the grant "because of the concern that stock options could not be reliably valued at the exercise date."[10]

As the use of such options increased, FASB in 1984 began to reconsider the earlier ruling by its predecessor. The current standard was spelled out eventually in October 1995 in FASB Statement No. 123 (FAS 123). It allows companies to choose between two methods of valuing stock options: "fair value" or "intrinsic value."

Companies that use "fair value" – about 500 of them at last count, including about 100 of the components of the S&P 500 Index – record an estimate of the fair, or market, value of the options as an expense at the time they are granted. Calculating fair value is necessarily difficult, if not impossible, since no established method exists. The "Black

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[6] "A False Cure for the Ills of Stock Options," William Baumol and Burton Malkiel, Financial Times (London), April 3, 2003.
[7] Congressional Budget Office, "Accounting for Stock Options," April 2004, p. 4.
[8] "As Regulators Propose New Stock Option Rules, Rutgers Professors Have New Data on Who Owns Them," press release, March 31, 2004. See www.rci.rutgers.edu/~blasi.

[9] Hall and Murphy, pp. 51-52.
[10] Dechow, P., Hutton, A., and Sloan, R., "Economic Consequences of Accounting for Stock-Based Compensation," *Journal of Accounting Research*, 1996, 1:2, p. 2-3.

Scholes" model, which won its inventors, economists Robert C. Merton and Myron S. Scholes, the Nobel Prize in 1997, is the dominant method for valuing call options that are traded on major exchanges. But "employee stock options differ from call options in several respects."[11] For example, employee options have a vesting period, are non-transferable, extend for long periods (two to four years) and are corporate securities. While FAS 123 makes reference to Black Scholes (and to the similar "binomial model" for options pricing), these models have been shown to have significant deficiencies for valuing long-term instruments such as employee stock options.

Even Warren Buffett, an advocate of expensing options, derides the most popular options-pricing model for these purposes: "It's crazy to use Black-Scholes," he said.[12] The investment firm of Warburg Pincus advised FASB: "We feel very strongly that these models [Black-Scholes and binomial] do not recognize the fact that employee options are non-transferable [and] are not liquid."[13] And, as an SEC commissioner stated recently, "I have yet to meet anybody who suggests that Black-Scholes is a good or even a fairly good indicator of the value of long-term compensation options, especially those in broad-based option plans."[14] Thus, as two think-tank scholars concluded, "Financial economists are still uncertain how to value these options."[15]

Companies that use intrinsic value usually record no expense at the time of grant. "The intrinsic value of an employee stock option" is defined as "the extent to which an option's strike price – the specified price at which the underlying stock may be purchased – is below the stock's current market price."[16] In other words, if the strike price is $30 and the stock currently trades at $35, then the intrinsic value is $5, but if, as is usually the case, the strike price is equal to or higher than the current trading price, then the intrinsic value is zero.

Under FAS 123, however, companies that elect the intrinsic-value method must "disclose the effects of fair value recognition on their income."[17] Such recognition comes in footnotes to financial statements, which are read closely by analysts and investors. Footnoted information on stock options can run to several pages (three pages, for example, in the annual report of Intel Corp.) and lists such details as number of options at various exercise prices, weighted average of the remaining contractual life of the option, and the weighted average exercise price – both for options outstanding and those exercisable.[18] Footnotes also explain methods of estimating the value of the options and

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[11] CBO, p. 6.
[12] "Buffett and Munger: In Their Own Words," Andrew Hill, Financial Times, May 5, 2003.
[13] FASB Comment Letter No. 194.
[14] Remarks by Paul Atkins at the American Enterprise Institute, Jan. 8, 2004, unedited transcript available at www.aei.org/events/filter.all,eventID.710/transcript.asp.
[15] Hassett, Kevin A., and Wallison, Peter J., "The Economic and Legal Consequences of Requiring the Expensing of Employee Stock Options Without Specifying the Valuation Method," unpublished paper presented at a conference at the American Enterprise Institute titled "Expensing Employee Stock Options Looks Like a Major Mistake," Jan. 8, 2004, p.
[16] CBO, p. 2.
[17] Ibid.
[18] See, for example, the annual report of Biogen, Inc., Cambridge, Mass., 2002, Financials, p. 29.

state the estimates. Many corporations provide more information about their stock options than about the sources of their revenue, their debt outstanding, and the other forms of compensation for their employees.

On March 12, 2003, FASB moved ahead on its long-held desire to require the mandatory expensing of options. On March 31, 2004, it issued its exposure draft, stating in a press release that the proposal came "in response to requests from investors and many other parties to improve the current accounting standards relating to employee stock compensation in financial statements."[19]

FASB says that the proposal "provides more complete, higher quality information for investors."[20]

That statement is highly questionable, as I shall explain.

The Role of FASB

Much has been made of the importance of maintaining the independence of the Financial Accounting Standards Board,[21] which is a private organization of trustees and executives. But the board is, by law, subject to oversight by the SEC, the federal agency with responsibility for financial markets and, thus, to the executive branch and the Congress, which oversees that agency. As FASB's website states: "The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934."[22] FASB was designated in 1973 by the SEC to set financial standards for U.S. corporations.

America's elected representatives not only have the authority but also the moral and legal responsibility to oversee the activities of the FASB, especially when its decisions can imperil the U.S. economy. FASB has a single mission, which it states this way:

"...to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."[23]

Federal policymakers have a far broader mission. For example, they are responsible for encouraging – or at least not *dis*couraging – economic growth, for preserving and

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[19] "FASB Publishes Proposal on Equity-Based Compensation to Improve Accounting and Provide Greater Transparency for Investors," press release, Norwalk, Conn., March 31, 2004.
[20] Ibid.
[21] Examples abound of claims that FASB's independence will be compromised through activity by federal policymakers. For example, two years ago, Edmund L. Jenkins, then FASB's chairman, stated, "We caution Congress that *any* legislation mandating particular actions or procedures by the FASB can compromise the very independence that the legislation seeks to enhance." ("FASB Chairman Comments on Proposed Legislation," press release, Norwalk, Conn., March 19, 2002; emphasis in original.)
[22] From the FASB website, at www.fasb.org.
[23] Ibid.

increasing jobs, innovation and competitiveness. Even if FASB's expensing proposal were cogent from an accounting and financial viewpoint (and it is not), it would be the duty of Congress to consider its economic impact. I do not have to remind you, as members of the national legislature of this responsibility. It is your job. You can't abdicate it. You can't farm it out to a group of unelected accountants.

Beyond economic matters, policymakers have a legitimate role in examining FASB decisions on their financial and accounting merits as well, as this subcommittee is now doing. Certainly, Congress does not wish a role in the day-to-day operations of FASB, but, in a decision of the magnitude of the proposal on options expensing issued March 31, Congress would be derelict if it did *not* review FASB's assumptions and reasoning and their new rule's consequences.

Evaluation of the Expensing Proposal

In 1972, FASB's predecessor determined that options should not be expensed when issued because they could not be "reliably valued." As a result, the majority of public companies provide copious information for investors to make their own judgments. In other words, instead of shoehorning vast amounts of information into a single, necessarily inaccurate number, firms give investors the data and let them come to their own conclusions. Over time, dilution reduces earnings per share accordingly.

This approach is perfectly sensible, and it offers investors what they need to know to establish sensible market prices for shares. The key to determining market prices, at any rate, is cash flow, not accrual accounting statements based on GAAP, or Generally Accepted Accounting Principles (which are the issue with the FASB proposal). As Charles Calomiris, Henry Kaufman Professor of Financial Institutions at Columbia Business School, and Glenn Hubbard, the dean of that school and former chairman of the President's Council of Economic Advisors, have written:

"Market prices are determined by informed buyers and sellers who devote their energies to estimating free cash flow and deriving the appropriate discount factors to apply to free cash flow estimates. Even if informed investors constitute only a small fraction of the total number of buyers and sellers, they play a central role in determining securities prices on the margin as buyers and sellers because they can marshal substantial resources to buy when prices are low and sell when prices are high relative to their informed view of appropriate valuation."[24]

Calomiris and Hubbard argue, therefore, that the "potential benefits of developing a single accounting standard for measuring the cost of stock options are small (or non-existent)."[25] Investors already have the information they need. Of course, if a single standard were readily apparent, then it would probably do no harm to adopt it. But there

[24] Calomiris, Charles W., and Hubbard, R. Glenn, "Options Pricing and Accounting Practice," unpublished paper presented at a conference at the American Enterprise Institute titled "Expensing Employee Stock Options Looks Like a Major Mistake," Jan. 8, 2004, p. 3.
[25] Ibid., p. 5.

is no such standard. We are in the same position as the earlier accounting standards board in 1972. "The valuation of stock options is a highly complex endeavor, an area where reasonable people can, and do, disagree significantly."[26]

The Congressional Budget Office states that "employee stock options are difficult to value precisely."[27] But this is surely an understatement. They are *impossible* to value precisely at the time of issue. "The likely value of employee stock options," says the CBO, "is likely to be different from the value predicted by models developed for exchange-traded options."[28] But those are the only models we have.

How different are the results likely to be? Calomiris and Hubbard use, as an example, options with a strike price of $45 that were issued to Microsoft employees and "were expected to be purchased" by J.P. Morgan for 25 cents, according to a report in the Seattle Times on July 9, 2003. Microsoft's 10-K report, filed on Sept. 5, 2003, Calomiris and Hubbard note, "valued its average stock options granted in 2001, 2002, and 2003, using the Black-Scholes formula, at prices ranging from $12.08 to $15.79." According to updated Black-Scholes analysis, using reasonable assumptions of volatility, the options were worth $8 – still, very far from the 25-cent market value.

So how does FASB handle the problem first identified in 1972? By fudging. The exposure draft says that "the fair value of equity share options awarded to employees [must] be estimated using an appropriate valuation technique." And what is that? First, the board says that since "closed-form models" (i.e., Black-Scholes and similar models) "may not be the best available technique," its members decided that a "lattice model…is preferable." (A lattice model attempts to take into account past records of early exercise and forfeitures of options.) But then the board decides "not to require the use of a lattice model at this time."[29] In short, "companies can choose from a variety of mathematical models, so long as they take certain factors into account, including estimates of a stock's volatility."[30]

The absurdity of FASB's decision is in full view. Robert Herz, FASB's chairman, stated in a speech in December that he agrees that accounting "should better reflect economic reality" and that "we are very cognizant of the real-world issues and concerns over fair value measurements, particularly the farther one gets from traded markets."[31] But those real-world issues are brushed aside in the effort to find a number – any number! – to stick onto a financial statement to represent the complexities of the fair value of an employee stock option.

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[26] Ibid., p. 6.
[27] CBO, p. 5.
[28] Ibid.
[29] FASB *Exposure Draft*, p. ii.
[30] "FASB Unveils Expensing Plan on Option Pay," Jonathan Weil, Wall Street Journal, April 1, 2004, p. C1.
[31] Robert Herz, "The Financial Reporting Partnership," speech to The American Institute of Certified Public Accountants, Dec. 12, 2003, p. 15, at www.fasb.org/herz_aicpa_12-12-03.pdf.

As Calomiris and Hubbard write, "Option valuation is a complex valuation problem that is best left to market analysts to estimate and debate. It is disingenuous, and not helpful to investors, to pretend that this difficult valuation can be solved adequately by an accounting rule."[32] Indeed, it is worse than unhelpful. It is downright misleading and confusing. Instead of shining a light on a company's financial health, expensing of options "may leave hapless investors blinded by a fog of incomprehensible calculations," writes Howard Gleckman in Business Week.[33]

Perhaps if a single method were prescribed – even an imperfect one – investors could gain a small benefit, at least knowing that every company is using the same system of calculation. But FASB rejects that approach and, within broad parameters, allows firms to make the choices themselves. Thus, FASB is introducing a new element of noise and distortion into reported earnings. The opportunities for manipulation by unscrupulous managers are enhanced, and no analyst will be able to take the GAAP accrual earnings of an options-using company seriously. Instead, FASB will, unwittingly, make pro-forma statements, which pull out the fair-value options estimates, the coin of the financial realm.

In their paper, Kevin Hassett and Peter Wallison write that, without a single options-pricing methodology, corporations – forced to choose among many possibilities – would open themselves up to expensive class-action lawsuits by disgruntled shareholders: "The state of affairs creates a serious legal risk for both companies and auditors to which the Board [FASB] seems oblivious."[34]

The shame is that all of these adverse consequences (and more, which I will explain below) are utterly unnecessary. Kip Hagopian, a well-known venture capitalist who sits on the board of several technology companies, says that, while "the fact that [employee stock options] *may* be a cost to the issuing company or to its shareholders has never been in dispute," the cost is contingent on many factors – such as whether the employee is still with the company and whether the stock is above or below the strike price years from now. Investors can see the effect of the contingency examining potential "diluted earnings per share," a figure that takes into account shares that are likely to be exercised.[35] They can also examine the extensive footnoted detail on the options themselves.

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[32] Calomiris and Hubbard, p. 14.
[33] "The Imperfect Science of Valuing Options," Howard Gleckman, Business Week, Oct. 28, 2002, p. 122.
[34] Hassett and Wallison, p. 22.
[35] Kip Hagopian, "Stock Option Expensing: Getting the Accounting Right," unpublished paper, March 29, 2004. Two years ago, President Bush came to a similar conclusion, saying, "I think once options are 'in the money,' they ought to be calculated in the dilution, that they ought to be dilutive in their earnings-per-share calculations." That's the current system. Options are "in the money" when the stock's market price is above an option's exercise price." A reporter at the time wrote that the president "said stock options shouldn't be treated as a corporate expense" and instead "should be handled precisely the way they currently are in annual reports." ("Bush Supports Businesses in Debate Over Changing Options Accounting," Michael Schroeder, Wall Street Journal, April 10, 2002.)

Again, there is no reliable method for valuing employee options. But FASB marches on. Why?

"My own fear," said Paul Atkins, an SEC commissioner, "is that FASB is basically getting into an area that's more of a political issue than a technical or accounting issue."[36] Atkins implied that the aim of FASB was to improve – according to its own vision – corporate governance and management. In the wake of the Enron scandals, some observers have argued that stock options were an incentive to the excesses and deceptions committed by managers.[37] In fact, the rise of stock options coincides with the greatest period of prosperity in American history, a stretch of more than two decades with only two shallow recessions. Still, at a time when roughly half of Americans own stocks,[38] Congress has become appropriately concerned about finding ways to discourage abuses like those at Enron.

But the role of rectifier does not lie with FASB. As Atkins said, "One thing that I am certain of…is that FASB should not be in the business of dictating what type of compensation should be paid by corporations to their employees. So I hope that this new stock options approach is not an attempt to dissuade companies from using stock options as a form of compensation."[39]

The reasons behind the FASB proposal – other than the professed clamor for accounting change (strikingly absent from public-opinion surveys) – are unclear. The effect will certainly be to "dissuade companies" from issuing options. And that discouragement may have adverse effects on the economy.

The Economic Impact of the Proposal

The expensing proposal raises an important question: If, as nearly all economists agree, the information currently provided about options by firms in their financial statements is adequate for investors to make sound judgments about the value of those firms, then how can the new proposal – which adds no new information – change the value of those firms in the stock market and, thus, have an effect on the economy?

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[36] Atkins.

[37] Typical is Charles Munger, vice chairman of Berkshire Hathaway, Inc., who has said, "In 90 percent of the cases, the handing out of options is excessive." (Quoted in "Options Vigilantes," *Forbes*, Dec. 23, 2002, p. 67.) In addition, the U.S. Secretary of the Treasury, John Snow, derided stock options in an Oct. 15, 2003, speech as a "freebie," claiming that, in many cases [options] shortened the time horizon of management and accentuated the 'short-term-ism' that addicted the markets in the '90s." There is, not surprisingly, no economic evidence for such views. In fact, the problem in the 1990s was that investors took too long a view, not too short. They were encouraged by long-term-thinking managers that companies that were losing money would make money somewhere in the future – lots of money – and bid up stock prices accordingly.

[38] American Council for Capital Formation, "Equity Ownership in America," October 2002, at www.accf.org. At the time of the study, some 52.7 million households, representing 49.5 percent of all U.S. households, owned stocks – up from 36.6 percent in 1992 and 19 percent in 1983.

[39] Atkins.

The Congressional Budget Office, in its new report, says, indeed, that the economy is "unlikely to have a significant effect on the economy" specifically "because the information has already been disclosed."[40]

But, with this judgment, the CBO raises a paradox: If the information is already disclosed, then why change the rule? It has only a weak answer: The FASB proposal "could make fair value information more transparent to less sophisticated investors."[41] In fact, the proposal will make that information far more confusing, as Calomiris and Hubbard show.

But what about the basic argument? No new information; therefore, no economic effects.

I believe this analysis is dangerously wrongheaded. I have spoken with many chief executives of companies that rely on stock options to lure the best and the brightest to their firms. Nearly all of these CEOs have the same reaction to expensing. It will reduce their reported earnings and thus their stock prices.[42] They will move quickly, therefore, to pare back their stock option programs, especially to employees below the top five corporate officers.

For example, America's best-known venture capitalist, John Doerr, said in testimony that he thought "broad-based employee stock ownership...will disappear if expensing is mandated."[43] A study by consultants at Mellon's Human Resources & Investor Solutions found that companies intend to cut back significantly on options programs for employees below the top executive level if expensing is enacted.[44] A review of the economic literature by Brian J. Hall and Kevin J. Murphy concluded that "parties on both sides of the debate agree that such a change [expensing options] would result in granting fewer options, especially to rank-and-file workers."[45] Dozens of chief executive officers have publicly stated that their firms will reduce or eliminate options if expensing is enacted. Typical is the CEO of Advanced Fiber Communications, who wrote in a letter to FASB: "The expensing of stock options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees."[46]

And what will happen if options are reduced or eliminated? According to Andrew S. Grove, chairman of Intel:

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[40] CBO, p. vii.
[41] Ibid.
[42] Using Black-Scholes would cut the reported earnings of high-tech firms by 70 percent, reported The Economist ("Now for plan B: expensing share options"), March 15, 2003.
[43] Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003; transcript at p. 55. Doerr has been a partner in the firm of Kleiner, Perkins, Caulfield & Byers since 1980. The firm has sponsored investments in such companies as Compaq, Cypress, Intuit, Lotus, Netscape, Sun Microsystems and Symantec, which have led to the creation of over 30,000 jobs.
[44] Mellon, "SFAS 123: Responding to Mandatory Option Expensing," September 2003 survey, p. 9.
[45] Hall and Murphy, p. 68.
[46] FASB Comment Letter No. 185. See also many others (Staples, Altera, Genentech, etc.), including, poignantly, FASB Comment Letter No. 29: "If options are expensed, I can tell you that a small company like the Vermont Teddy Bear Company will no longer grant them."

"For years, the U.S. economy has increasingly been driven by the contributions of knowledge workers. Broad-based stock option plans offer the opportunity of ownership and provide owner-like motivation to knowledge workers. After 40 years in a knowledge-based industry, I do not know a better way to achieve this sense of ownership – not even a close second.... [W]e routinely grant more than 97 percent of our stock options to employees other than the top five members of management; by doing so, we are using a powerful incentive and retention tool for the benefit of all of our stockholders."[47]

Doerr, the Silicon Valley venture capitalist, says that the fallout from expensing options "is a big competitiveness issue.... The innovation economy is where we're going to get the growth in jobs and the economic security for Americans.... The use of broad-based employee stock ownership, which I contend will disappear if expensing is mandated...delivers higher returns to the shareowners of the companies who use them, produces higher productivity, higher returns on equity, higher returns on assets, accounting the effects of dilution."[48]

At a time when Americans worry that jobs are going overseas, the expensing of options could encourage the exodus. In an article in Barron's, George Chamillard, the CEO of Teradyne, a Boston-based maker of automatic testing equipment for the electronics industry, wrote that one major factor in the "flight of the semiconductor industry from Route 128 [near Boston] to Silicon Valley" was "stock options." Bay Area start-ups "were romancing East Coast talent with the opportunity to strike it rich through options.... Stock options were a low-cost way to draw talent away from mature companies and into stat-ups. In return for assuming higher risk, the options-givers offered the recruit the chance for high rewards through equity ownership and a piece of the action.... Other industries learned the lesson well, using options to drive new companies and inject excitement into older ones."[49]

Now, writes Chamillard, the next cycle of "Go West, Young Man" has begun. "While options are under attack in the U.S., elsewhere the stock option as a recruiting tool is on the rise." Options are drawing scientists from the U.S. to Asia – Taiwan, in particular. As a result, he writes, the U.S. is losing "engineers educated at MIT and Stanford and CalTech."[50] Asian nations understand the attraction of options, and they do not have the same fetish for expensing them as American regulators have.

Even China, in its 2001-2005 five-year plan, officially encourages the use of stock options to motivate managers.[51] And a recently study by the consulting firm Towers Perrin found that, in Asia, with the exception of Singapore, "stock options still remain companies' most popular long-term incentive for their executives."[52]

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[47] Andrew S. Grove, "Letter from your chairman," Intel Corp. annual report, 2002, www.intc.com.
[48] Doerr.
[49] "Go West Again? Lured by Stock Options, Techland's Best and Brightest Moved to California; Next Stop, Asia?" George Chamillard, *Barron's*, July 21, 2003.
[50] Ibid.
[51] Five-Year Plan of the People's Republic of China (2001-2005).
[52] Agence France Presse, Sept. 24, 2003.

With the economic recovery in the United States still young and unstable, this is not the time to be gambling with a measure that could chase jobs to Asia.

The Impact of the Proposal on Investors

FASB's proposal is more likely to confuse investors than to enlighten them. For companies that retain options plans, investors will have to rely on pro-forma statements that eliminate the distortions caused by huge, non-cash options-cost estimates. Go back to first principles. William A. Sahlman writes, "What an investor cares about most is her percentage claim on the after-tax free cash flow generating capacity of a company. Accounting machinations often affect reported income but not cash flow. [Stock options] affect the percentage claim someone has on a company's cash flows – the more options outstanding, the lower the potential ownership of the outside investor."[53] And that effect, of course, is duly noted under the current regime, which both discloses the potential shares that would have to be issued to satisfy the exercise of options and, at the appropriate time, shows the dilutive effect on earnings per share. In other words, stock options are a cost, not to the company, but to its shareholders.[54] This is a point made cogently as well by Walter P. Schuetze, former chief accountant of the SEC, who told Sen. Charles Schumer in a letter two years ago that "I would not charge expense for stock options issued to employees."[55]

There is another side to options that is missing in the accounting debate. "Granting stock options," writes Prof. Sahlman, "will also affect the level of...prospective cash flows." And *this* is what investors should care about. "The CEO will have strong incentives to increase value per share because of the stock option grant."[56] Others who receive options will have similar incentives.

In other words, whatever cost is assigned to options, it should – in the case of well-run companies – at least be balanced by the likelihood of higher cash flow. "A number of academic studies," write Baumol and Malkiel, "support the observation that employee stock options have an incentive effect sufficient, or more than sufficient, to cover their market value."[57]

Because of the change in accounting rules, small investors are apt to get the impression that serious expenses are at last being charged to companies that had previously evaded

[53] Sahlman, William S., "Some Thoughts on the Accounting for Stock Options, July 24, 2002, p. 2. Sahlman if the Dimitri V. d"Arbeloff-Class of 1955 Professor of Business Administration at the Harvard Business School. See also his article, "Expensing Options Solves Nothing," Harvard Business Review 80, no. 12, pp. 90-96.

[54] This point was made forcefully by Dennis Powell, chief financial officer of Cisco Systems, in testimony before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003, p. 25: "In the last six months, I have surveyed in face-to-face meetings over 50 of our largest investors, and I've asked them that specific question: Who bears the cost of the options that are outstanding? Is it the company or is it the shareholders? One hundred percent of them recognized that this is a cost that is borne by the shareholders. It's not an expense of the company."

[55] Letter from Walter P. Schuetze to Sen. Charles E. Schumer, March 25, 2002.

[56] Sahlman, p. 3.

[57] Baumol and Malkiel.

them. In fact, the change will not affect cash flow at all – except, perversely, by lowering the prospect of future cash flows as firms are pressured to give up their options plans.

The Impact of the Proposal on Accounting

The accounting profession faces a crisis. But it has nothing at all to do with stock options. My AEI colleague Peter Wallison, with Robert Litan of the Brookings Institution, argue forcefully in their book, *The GAAP Gap*, that GAAP accrual earnings by themselves do not reflect corporate health and cash-flow prospects.[58] One reason is that the assets of companies in a knowledge-based economy do not show up on balance sheet. "An estimated 80 percent of the value of the Standard & Poor's 500 is made up of intangible assets of all kinds. [As a result], the earnings of companies in today's knowledge economy are of higher quality than the earnings of traditional companies. Whatever their absolute amount, the earnings produced by internally generated intangible assets have already been reduced by costs that in traditional companies would be capitalized and written off over time."[59]

In other words, while intellectual work by designers, researchers and engineers provides a business with productive, revenue-producing assets, this work does not appear on the balance sheet; instead, "salaries of employees are written off as they are incurred."[60]

The great challenge for accounting is reconciling this new reality with the antiquated tools of GAAP, developed at a time of large industrial companies with easily identifiable tangible assets like factories and machine tools.

Unfortunately, the response to the scandals at Enron, WorldCom and elsewhere has led accounting policy off the path toward meeting this challenge. Instead, the reaction has been "to enshrine the audited financial statement...as the principal disclosure of companies whose shares are traded in the public securities markets.... [But, in fact,] there is strong evidence that investors are relying on many other factors other than audited earnings in making judgments about the value of companies, particularly free cash flow."[61]

Rather than trying to quantify the unquantifiable, as FASB is attempting in its options-expensing proposal, accounting policy should follow a different strategic path, moving instead toward other, non-GAAP metrics, which can tell investors more. Indeed, the use of intrinsic-value, as opposed to fair-value, disclosure is on the right track. But FASB wants to derail it.

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[58] Wallison, P., and Litan, R., *The GAAP Gap* (2000), American Enterprise Institute.
[59] "Accounting Lags Behind a Knowledge Economy," Peter J. Wallison, Financial Times (London), March 8, 2004.
[60] Ibid.
[61] "Poor Diagnosis, Poor Prescription: The Error at the Heart of the Sarbanes-Oxley Act," *On the Issues*, Peter J. Wallison, American Enterprise Institute, March 18, 2003. See www.aei.org.

Conclusion

The FASB proposal for options expensing must be significantly modified or, better, withdrawn. Congressional and executive-branch policymakers have a responsibility to step in – because FASB's own mandate, which extends only to accounting rules, is so limited and because the law establishes the SEC as the agency to set accounting policy, a role it has assigned to FASB. Elected policymakers must take into account the impact of accounting rules on the economy – and the impact of the proposed rule could be significant, harming U.S. competitiveness and growth and chasing jobs overseas.

FASB's proposal would be more cogent if it provided a single methodology for valuing stock options at the time of issue. But FASB cannot do this, just as its predecessor could not in 1972. No such methodology exists. The result will be confusion for investors and the possibility of expensive class-action lawsuits.

It is remarkable that FASB's proposal has come this far. There is no public clamor for it, and there is much opposition from America's most innovative firms – for good reason. Instead of misleading investors by insisting on a single number for a complex phenomenon, FASB should devote its considerable intellectual capital to solving more significant problems of accounting policy in a knowledge economy.

Thank you.

AMERICAN INSTITUTE OF CERTIFIIED PUBLIC ACCOUNTS

The American Institute of Certified Public Accountants is the national, professional organization of CPAs, with more than 330,000 members in business and industry, public practice, government and education. It sets ethical standards for the profession and U.S. private auditing standards. The AICPA believes that setting accounting standards must remain in the private sector with the Financial Accounting Standards Board (FASB). The failure to do so will lead to less transparency in financial statements, hurting investors in public companies.

The issues of the use of stock options and their treatment for accounting purposes has been highly controversial for over a decade. Many companies argue that the use of stock options is essential to their ability to attract and retain the best and the brightest to their workforce. Further, they argue that there is no accurate way to measure the cost of stock options and that the mandatory expensing of those options would severely limit or eliminate their ability to use stock options.

Conversely, many companies and investor groups argue that stock options have a real cost that must be reflected on the income statement. They argue that failure to do so distorts the true financial condition of the company and thus misleads investors. Many of these companies currently account for stock options in their financial statements on a voluntary basis.

Currently, the FASB is considering the issue of whether the expensing of stock options should be mandatory, and if so, how they should be measured. The AICPA believes it is imperative that the FASB be allowed to complete its process without the intervention of Congress.

Since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress has recognized that the private sector, pursuant to a delegation of authority from the SEC, should set accounting standards for publicly traded companies, subject to SEC oversight. FASB was created in 1973 to continue the process of promulgating GAAP rules. In 2002, Congress once again recognized the importance of maintaining a strong and independent body to set accounting standards in the Sarbanes-Oxley Act. It strengthened the FASB by requiring that it has a truly independent board of trustees, an independent source of funding, and has procedures in place to ensure the prompt consideration of accounting principles necessary to reflect emerging accounting issues and changing business practices.

Congress has taken these actions because it has recognized the value in having accounting principles set by an independent, objective body of financial reporting experts who would not allow political considerations to influence the content of accounting rules. Accounting rules are based on the concept that the financial statements of a company need to fairly represent the financial condition of the company in order to safeguard investors. They are not, and should not be, based on a concept of rewarding or discouraging a company from acting in a certain way.

The use of stock options is a perfect example of this principle. Ten years ago stock options were held in high regard as a means of giving management and employees a stake in the company, thus providing an incentive for loyalty. They also became a means for cash poor start up companies to hire and retain workers where the company was unable to pay the large salaries necessary to retain workers.

Today, it is alleged that options were subject to abuse by some corporate executives who manipulated earnings in order to increase the stock price and make their options more valuable. If Congress wants to address the issue of the abuse of stock options it should not do so by micro managing the content of the financial statement. Financial statements must be structured to fairly represent the financial condition of the company in order for them to be transparent, and thus serve the interests of investors. Using financial statements for any other purpose than fairly representing the financial condition of the company makes them more opaque and thus masks the true financial condition of the company from investors.

Allowing FASB to determine the proper accounting treatment for stock options will mean that the treatment will be fairly reflected in the financial statements. For Congress to intervene in the issue of the proper treatment of stock options would mean that accounting rules would reflect considerations other than fairly representing the financial condition of the business. This does not promote transparency in financial statements and thus is not in the best interests of the investor. Therefore, we urge you to oppose all legislative initiatives that would undermine FASB.

Statement of

The Association for Investment Management and Research®

Senator Peter G. Fitzgerald
Chairman
Subcommittee on Financial Management, the Budget, and International Security
U. S. Senate Committee on Governmental Affairs:
446 Senate Hart Building
Washington, DC 20510

Senator Fitzgerald:

The Association for Investment Management and Research (AIMR®) is pleased to present its views on the importance of an independent Financial Accounting Standards Board (FASB) in setting financial reporting and accounting standards. We hope that our comments will assist the Subcommittee on Financial Management, the Budget, and International Security (the Subcommittee) to evaluate FASB's proposal to require mandatory expensing of employee stock options at their fair value, and to better understand the economic and financial reporting impacts of such expensing.

AIMR is a global, non-profit organization whose members include more than 70,000 investment professionals and educators in 116 countries, as well as 129 affiliated professional societies in 48 countries. The AIMR mission is to lead the investment profession globally by setting the highest standards of education, integrity, and professional excellence. Most notably, AIMR is known for the Chartered Financial Analyst ® (CFA®) curriculum and examination program, the globally recognized standard for measuring the competence and integrity of financial analysts and fund managers. Almost 57,000 AIMR members are holders of the CFA® designation. AIMR is also known for the development and implementation of AIMR's *Code of Ethics and Standards of*

Professional Conduct. Additional information about AIMR is available through its website (www.aimr.org) or in its annual report.

Fundamental Principles

An integral part of AIMR's service to investors and the investment community has always been advocacy on behalf of investors and in support of the efficiency and effectiveness of global capital markets. Recognizing the centricity and importance of financial statements to investment analysis and decision-making, AIMR has, for more than 25 years, provided comments and other input to financial reporting standard-setters, including the FASB, on the needs of investors. These comments have been based on several core principles:

(1) **Investors' needs for information must come first.** There should be reasonable disclosure of information to the capital markets to permit well-informed decision-making.

(2) **Financial statements exist, first and foremost, to help investors make informed investment decisions**. Efforts to improve the quality of financial reporting and disclosure must be assessed in light of what benefits those who *use* financial statements, not those who prepare them. Perhaps even more importantly, the *cost* to users of having inadequate information for decision making must also be measured and included in any cost-benefit analysis undertaken.

(3) All markets should be transparent and regulation should operate to this end. **Financial statements, therefore, must be unbiased and complete.** No one should be permitted to manage financial reporting information to make companies appear more (or less)

profitable than they are. Financial statements must not be distorted or provide selective information even to support worth endeavors like more easily attracting employees or increasing compensation. That is not the function of financial statements.

(4) There should not be a two-tiered disclosure system. The same information should be available to all market participants at the same time. **When information is important for decision-making, it should be made accessible to all market participants, not just those with the expertise, time and resources or who know where to look.**

(5) Regulation and legislation, if any, should be designed and enforced to maintain and enhance market credibility, openness, and investor confidence, thereby helping lower the cost of capital. **Politics and financial reporting standards don't mix.** Accounting standards should be set by an independent and objective group of experts, free from political pressure, after careful study and an open comment period in which feedback is invited from all constituents. That is the FASB's mandate. Elected officials must overcome the temptation to intervene and set a "politically correct" agenda for an independent standard-setter.

The Financial Accounting Standards Board Must Be Independent and Free from Political Intervention

AIMR actively supports the work of the FASB. Prior to the change in the FASB's funding mechanism, AIMR, as a constituent organization of the Financial Accounting Foundation, provided financial support. Recognizing the critical nature of financial statement information to the investment decision-making process, AIMR staff and its member-volunteers continue to work hard to ensure that the investor viewpoint and user community needs are included in the deliberation and debate that result in financial accounting standards, such as the proposed *Share Based Payments.*

Individual investors rarely have the political influence that corporations have and, hence, are disadvantaged when corporate influence adversely affects the information on which they rely when investing their savings. AIMR strongly believes that U.S. legislators must demonstrate their conviction, so adequately articulated in Sarbanes-Oxley, that only an independent standard-setter can achieve the necessary balance across divergent interests and needs. Furthermore, we are convinced that the FASB process is inclusive and fair to all affected parties: corporations and other preparers of accounts, auditors, investors, regulators, and others. As investor advocates, we can testify to the FASB's continuing adherence, in the face of strident opposition, to precepts of objectivity and fairness, and to its efforts to carefully balance the costs and benefits to users against the costs to preparers and auditors.

Now is the time for legislators to support the FASB in its endeavor to achieve a financial reporting result, one that investors and their advocates have been waiting for 10 years to be implemented. After the billions of dollars that investors have lost in the last four years, due partly to weaknesses in the financial reporting system, AIMR urges Subcommittee members and their colleagues to refrain from intervening in the independent standard-setting process and permit the FASB to move forward with its proposal for expensing employee stock options.

Investment Professionals Use Fair Value Information About Employee Stock Options; Individual Investors Deserve Easy Access to the Same Information

There is compelling evidence that investment professionals use the information currently available in the footnote disclosures to adjust expenses and earnings. In 2001, as the debate about expensing employee stock options heated up, AIMR sent a survey to 18,000 of its members to determine the relevance of information about the fair value of employee stock options. Over 1,900 investment professionals responded, including equity and fixed income analysts at investment management firms (26 percent of respondents) and brokerage houses (15 percent), as well as fund managers for institutional or private clients (38 percent). Seventy-five percent of respondents were from North America, 13 percent from Europe, and 10 percent from the Asia-Pacific region. Disclosure of information about stock option plans was shown to impact a significant number of analysts and portfolio managers, with 85 percent of respondents saying the companies they evaluate have such plans.

The survey results support our hypotheses and provide considerable evidence to support upgrading the required accounting treatment:

- 88 percent of respondents believe share-based or stock option plans are compensation
- 83 percent said the accounting method for all share-based payments (including those given in employee stock option plans) should be expensed in the income statement
- 74 percent said that the current accounting requirements need improving; a majority said that expensing should be required while some said disclosures should be enhanced to give

better information about potential dilution and the cash impact of related stock repurchase plans and exercised options.

- 81 percent use information about the value of stock options when evaluating a firm's performance and determining its value. Two-thirds use the information wherever it is disclosed, while 15 percent use it only when recorded as an expense.

(These results are available on the AIMR website at www.aimr.org/pressroom/surveys.html).

With the confirmation that investment professionals are "expensing stock options" on their own (even without the conceptual accounting arguments in favor), AIMR gave its full support to the FASB proposal because it is our firm belief that all investors, no matter how unsophisticated, would be better off if this information were made transparent by recording it as an expense. When so many investment professionals use this information, we believe it is simply a question of fairness to make it easily accessible to individual investors.

Investors Need Companies to Expense Employee Stock Options at Fair Value

It is well understood, and unarguable, that investors need accurate, complete, consistent, comparable, and unbiased information from competent sources to make informed investment decisions and to allocate their hard-earned money wisely among investment alternatives. In other words, when financial information lacks these characteristics, investors cannot make appropriate investment decisions, and markets cannot be efficient or effective in their primary role of allocating capital. Indeed, these principles underlie the Congressional mandate, in the Securities and Exchange Acts of 1933 and 1934 and later amendments, to the Securities and Exchange

Commission (SEC) to oversee the formulation of accounting standards and the required audit of all SEC registrants.

Traditionally, the best source for this information is a company's financial statements. These and other corporate communications are indispensable to investors for developing a picture of a company's financial position, stewardship of assets, current performance and future outlook. Therefore, it seems logical that if investors identify specific information that would make the "picture" more accurate, companies would not only provide the information, but do so in the most "transparent" way – meaning the information is readily accessible to the most readers and is communicated in a clear, understandable way. Expensing stock-based compensation can only improve transparency and increase accessibility for all investors.

AIMR Response to Arguments Against Recognition and Fair Value Measurement

Opponents of expensing employee stock options at fair value have put forward several arguments that we would like to address:

1. Stock options are not really compensation, or at least they shouldn't be treated as such.
2. Investors don't or won't use this information, or will be confused by it.
3. Estimating the fair value of stock options is too costly for companies to provide.
4. The fair value of stock options can't be measured, or estimates of its measurement would be too unreliable.

5. Recognizing an expense will have negative effects on small, growth, and start-up companies' ability to attract high-quality management and, hence, the end of entrepreneurship.

AIMR believes that none of these arguments is sufficiently valid to warrant prohibiting the FASB to finalize this standard and we will address each in turn.

Stock Options Are Compensation and Should Be Reported as Compensation Expense

First, it is imperative that we agree that stock options awarded to employees are compensation. In the past, some opponents of stock option expensing have argued that stock options aren't really compensation. But this spurious claim has been largely abandoned because its adherents are unable to explain *what else* stock options are, if not compensation, and *why* executives and other employees are so anxious to accept them, oftentimes in lieu of cash compensation.

Even J. Carter Beese Jr., former SEC commissioner and opponent of expensing stock options in the 1993-94 debates, admitted that "employee stock options provide unique benefits that salaries, commissions, and other pay forms lack. These benefits — which include linking pay to performance and allowing cash-poor start-up companies to hire and retain key employees, as well as providing incentives for all employees to be more productive — are valuable to all companies and to the economy as a whole."

AIMR agrees that it is important for all companies to attract high quality management and employees. Hiring and retaining these employees requires good, competitive compensation packages. Certainly, prospective employees weigh the trade-offs between cash and other forms of compensation when valuing the total offering. While some types of options contracts may be less than optimal from an investor perspective, there is no reason for companies to eliminate stock options from their compensation repertoire.

However, because employee stock options are useful compensation tools does not mean they should get a dispensation from good accounting. When compensation is paid in cash, it is expensed. When paid in goods or services, it is expensed. When stock options are awarded to non-employees, such as attorneys, for services rendered, they are expensed. Since it can't be *the fact* of the compensation or its *form*, per se, that explains why less transparent accounting should be permitted, we question why the nature of *the person* being compensated (in this case, an employee) would do so. We believe that shareowners and investors have the right to know the full cost of executive and employee compensation.

Under existing accounting rules, performance is primarily measured on the income statement, and costs of production are recorded as expenses. As compensation, stock options are a cost of the production of goods and services. All costs of production should be recognized appropriately for accurate measurement of a company's performance.

Investors Are More Easily Misled When Expenses Are Hidden and Income Overstated

If employee stock options are compensation and should be treated as such, the question still remains whether the information is relevant to investor decision-making. Even if there were no evidence that investors used this information, failure to recognize and measure stock option awards as compensation expense is conceptually bad accounting. Not recording employee stock options as an expense understates not only the cost of compensation, but also the cost of production. Consequently, a company's net income is overstated. Without making the necessary adjustments to net income, investors risk making poor decisions about whether to buy, hold, sell, or avoid a particular company's securities. Failure to accurately measure compensation and net income also impairs investors' ability to compare companies with different compensation structures, and it unfairly inflates the performance of companies that rely heavily on stock options (whether or not they are cash-poor) relative to those who pay their employees in cash or other "hard" assets.

In 1994, opponents of recording employee stock option expense won a political victory when the Financial Accounting Standards Board agreed to require only footnote disclosure of the value of employee stock options rather than requiring options to be expensed. As we reported in the discussion of the AIMR survey results, investment professionals have determined that the footnote disclosure information on the fair value of employee stock options is both relevant and sufficiently reliable to use in their analyses and valuations. Therefore, we believe that it's past time to reconsider the FASB's earlier decision, bring the information out of the obscurity of the footnotes, and put it on the income statement where it will be transparent and accessible by even the least astute financial statement reader.

Companies Already Bear the Cost of Estimating the Fair Value of Employee Stock Options

Because companies generate the required information already, any increased cost of recognition should be marginal relative to the benefit to investors from improved transparency and comparability. If the numbers currently being reported in the footnotes are reliable, a "too costly" argument isn't credible. If the footnote numbers are *not* reliable, then those investors currently using the footnote disclosures deserve better information, and companies have a responsibility to provide it.

Rather, the cost that we should be most concerned about is the cost to the investing public of relying on inadequate or inaccurate information, inappropriately assessing a company's risk and return profile, and making poor investment decisions has already been measured by the millions of dollars lost in the failures of Enron, WorldCom, et al.

Almost All Financial Reporting Numbers Are Estimates; Estimates of the Fair Value of Stock Options Can Only Improve If Expensing Is Required

Those knowledgeable about financial reporting understand that each and every number in the financial statements, including at times "cash and cash equivalents," can be an estimate. The values of receivables, inventories, fixed and intangible assets, as well as pension liabilities, lease obligations, etc., are based on recorded historical costs (sometimes estimated or allocated) which are adjusted, either initially or over time, using various assumptions and estimation methods.

For example, we ask that you consider the reliability of the book value of an aircraft engine whose initial cost required allocation of the total cost of an aircraft to its various parts, an estimation of its useful life and its salvage value, potential impairment and write-down over time. Yet companies that own aircraft must make these assessments and estimations all the time, and expect investors to rely on them. Therefore, we cannot understand companies' specific concerns about estimation error with respect to stock options.

We understand that companies are more comfortable estimating useful lives, salvage value, and depreciation expense because they have a lot of experience using the methods. We believe that companies will gain similar experience with using the available option pricing models and confidence with the resulting fair value estimates, too. Valuation methodologies will improve over time — and in fact have a better chance of doing so — when companies have a real need for them.

Despite their concerns about the reliability of estimates for financial reporting purposes, companies trust these valuation methods in other areas. Trillions of dollars in options are traded worldwide using estimates based on the Black-Scholes model or other option valuation techniques. Some of the same companies that object to use of these models for financial reporting purposes in fact use the very same ones to value exchange-traded or over-the-counter option contracts for hedging or speculation purposes. Furthermore, when compensation contracts with executives and other employees are under negotiation, these same models are used to determine the number of options the employee will receive, and for internal and external contracting, including compensation awards. If the measurements provided by these models are good enough for the individuals who accept stock options in lieu of other compensation, they are reliable enough for investors.

Financial Statements Must Not Be Distorted to Achieve Other Objectives

This leaves the argument: that some companies — especially start-up companies, entrepreneurs, and those that rely heavily on such compensation — will be unable to attract quality management if they have to decrease net income by the fair value of employee stock options. AIMR believes that this argument does little but act as a distraction from the real issue: the purpose of financial reporting information and the right of investors to complete and comparable information about a company's financial position and performance.

Attracting and hiring high quality employees is a worthy and necessary objective for all companies. Designing compensation packages to do so is a necessary element in that process. Recognition and measurement of an expense in the company's income statement should not prevent it from using employee stock options to compensate employees. Rather recognition and measurement will make the estimated value of those options explicit to the employee, company management, its shareowners, and potential investors so that each can use that information in their respective decision-making.

Entrepreneurs existed before stock options as we know them were available as a compensation tool, and we have every confidence that bright, creative, risk-taking individuals will continue to develop their ideas and create successful business enterprises. To attract external investors with integrity, these entrepreneurs must provide the highest-quality accounting and disclosure information so that investors can assess the real risks and rewards of such companies.

Summary

Since 1993, AIMR has publicly advocated recording the fair value of employee stock options as an expense on the income statements of companies that use them. We believe that failure to do so violated the conceptual framework that underpins all financial reporting and disclosure and distorts financial statements to achieve ends that are not only inappropriate but act contrary to the needs and rights of shareowners and investors.

Companies continue to argue that this information will not be used or is not reliable. Since there is compelling evidence that investment professionals do use this data, we believe that it must be made more accessible to individual investors. In addition, its use by investment professionals also provides evidence that the footnote disclosure measurements have sufficient reliability for investment decision-making. We believe improvements in reliability will only occur when measurement and recognition are mandated.

Finally, we urge the Subcommittee members and other senators and congressional representatives to fully support the independence of the Financial Accounting Standards Board and avoid the temptation to interfere in this independent process by passing legislation on this issue. The standard-setting process does not always create standards that fully meet the needs of investors and shareowners, but we strongly believe that the process is fair and works to balance the often conflicting needs and concerns of its constituents. Politicizing the process will only work to destabilize it, to the detriment of investors who have the least ability to gather political influence.

AIMR appreciates the opportunity to comment to the Subcommittee on the independence of the Financial Accounting Standards Board and the need for expensing of employee stock options at fair value. These issues are of critical importance to investors and other users of financial statements as well as to financial markets generally. If you, the Subcommittee members, or their staffs have questions or seek additional comments, please feel free to me at 1.434.951.5315 or patricia.walters@aimr.org.

On behalf of the Association for Investment Management & Research,

Patricia Doran Walters, PhD, CFA

Senior Vice President, Professional Standards & Advocacy

Cc: Thomas A. Bowman, CFA, President & Chief Executive Officer

Raymond DeAngelo, Executive Vice President, Member & Society Division

Rebecca T. McEnally, CFA, Vice President, Advocacy

Statement for the Record

By

William R. Sweeney, Jr., Vice President

On Behalf of

Electronic Data Systems Corporation

To the Senate Subcommittee on Financial Management, the Budget, and International Security

For the Record of the Oversight Hearing on April 20, 2004

On

Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board

To: Chairman Peter G. Fitzgerald and Ranking Member Daniel K. Akaka:

We are pleased to respond to your request to provide written testimony to the Senate Subcommittee on Financial Management, the Budget, and International Security (the "Subcommittee") detailing EDS' position on the expensing of stock options and other stock-based compensation to employees. EDS supports all accounting standards that promote accurate financial reporting, improve the usefulness of financial information and enhance the comparability of financial information among companies and industries. Accordingly, we support the current efforts by the Financial Accounting Standards Board (FASB) to improve the accounting for stock-based compensation to employees.

We recognize a growing number of shareholders and other financial statement users believe expensing options and other stock-based compensation will more fully represent the economics associated with these transactions. Expensing options would also be an important step towards the standardization of global accounting rules, an important priority to EDS. However, measuring the true economic value of employee stock-based compensation is inherently difficult. Creating a standard that will ensure the accurate valuation of an employee stock option that has no realizable value when issued and may ultimately be forfeited or expire worthless is a significant challenge. Nonetheless, EDS supports this position as long as such accounting involves the use of a practical valuation methodology that will yield accurate and comparable results among companies and industries.

As part of their ongoing effort to address these concerns the FASB issued an exposure draft on March 31, 2004. The FASB's stated objectives for the exposure draft include simplifying the accounting requirements, improving the comparability of reported information and increasing the usefulness of the stock-based compensation information reported in financial statements. The exposure draft would require companies to expense employee stock options and other employee stock-based compensation and provides guidance for measuring employee stock-based compensation.

We fully support the objectives and independence of the FASB and will continue to do all we can to play a constructive role in their efforts to improve financial accounting. In that regard, we are reviewing the FASB's exposure draft on stock-based compensation and will provide our comment letter on such draft to the FASB within the next few months. While all such letters are publicly available on the FASB's website subsequent to submission, we will be pleased to provide the Subcommittee with a copy of our letter upon its submission to the FASB.

Thank you for the opportunity to provide our testimony.

Why Stock-Option Compensation Stunts Growth and Destroys Jobs.

Statement of the Coalition to Stop Stock Options
for Hearing on Expensing Stock Options,
April 20, 2004, U.S. Senate Committee on
Government Affairs, Subcommittee on
Financial Management, Budget and Security

Compensation with stock options has mushroomed over the last decades because current accounting standards treat stock options as if they were free. Reporting stock options as if they were free is deceptive accounting. The options have value when issued and they mature into stock that diverts significant cash from other investors.

The sacred mission of accounting is to help channel capital toward the projects that are best on their merits. The lie that stock options are free gets in the way of that sacred mission. Treating options as free lures investors into bad companies. Top managers also exploit the rule by paying themselves too much, schnookering more money out of their shareholders than they could otherwise get. Both effects waste precious capital. When precious capital is wasted and diverted, the growth of the whole economy is stunted. Deceptive accounting stunts growth and destroys jobs.

Support the FASB. The Financial Accounting Standards Board has just proposed a revision to accounting standards that would require the company to report the fair value of an option as a cost. FASB has tried to end the zero-costing rule in the past. But top management likes reporting their compensation as free (Wouldn't you?) and they have defeated prior reform. They are trying to defeat honest accounting now too.

Zero costing. Under current accounting standards, options set up to have no initial bargain at the time the option is granted can be reported by the corporation at zero cost. The rule dates back to 1972 when there were no well established markets for options nor good valuation theory and option compensation was of trivial importance.

Options aren't free. Zero cost for an option with no initial bargain is not a good faith effort at measuring cost. When the company proves successful, the holder gets the stock, and at a tremendous bargain price -- the value of the stock ten years before. If the company fails, the option holder avoids all loss, just by not exercising the option. An option is like betting on the horses, after the race is over and without having put up the capital that allowed the horse to run. For high-risk companies, the holder of the option holds most of the value of the underlying shares.

Just a proxy for cash. The stock issued in response to an option is certainly not free, from the perspective of the issuing company or its shareholders. All stock shares in the corporation's cash flow. The new shareholders divert cash of the corporation from the old shareholders. The value of stock and stock options is nothing but the discounted present value of the cash that the corporation is expected to pay. The option is no more free than the cash the corporation must ultimately pay out and divert from others.

Bad Business: Hurt the Company. Stock options are bad business, first, because they give CEOs incentives to hurt their own corporation. Option holders participate in gains, but not losses. CEOs with substantial stock options have an incentive to go into projects with too much risk. Projects that have negative expected value to the shareholders because of the loss possibilities can have very strongly positive value to the

CEO option holder. An option-holding CEO, looking only to his own personal stake, will rationally send the company into ventures that should scare the flesh off a shareholder.

Bad Business: Stop Dividends. Options are also bad business because they give the CEO an incentive to stop dividends. Accumulation of earnings will enhance the value of the options. Distribution of earnings will lower the value of the option. Shareholders are often richer when they get dividends, especially under recent tax law changes which enhance the after-tax value of dividends. But a CEO with options has a personal incentive to withhold dividends even while hurting shareholder value.

Bad Business: Excessive discount rates. Options are also bad for business because the discount rate used to calculate the value of stock and stock options is brutally high. If the corporation would avoid the high discount rate, by other kinds of compensation, either executives would get more present value from the cash the corporation will pay or the company would have to pay less cash, or both.

Toxic volatility. The market demands high discount rates in valuing stock and stock options because of unwelcome volatility in the price of the stock. Executives will take anything free, but, in truth, executives hate the volatility even more than the average stockholder because executives tend to be tragically under-diversified. The volatility on employer stock hits the executives like an electrical shock. Most of the unnecessary volatility can be filtered out of compensation by subtracting industry-average performance, but only if management gives up the accounting pretense that their compensation is free. The high discount rate also comes also comes because the discount rate does not give interest deductions to the corporate employer, whereas other forms of incentive compensation do.

Measuring the bargain. The value of an option when it is granted is just an estimate and estimates turn out wrong. But that objection can be easily met just by measuring the bargain the option will give, as it arises and fluctuates. Measuring the bargain on the option as it arises is easier and more accurate than estimating the value at first. The difficulties of estimating value at first, in any event, are not a reason for using a clearly wrong and deceptive value, zero cost.

Summing up. Stock options, in sum, are bad business because they rely on excessive discount rates to determine value. Better management of the discount rate would improve the corporation's wealth or the executive's wealth or both. Stock options give the CEO a private stake in destroying shareholder value, by withholding dividends and taking on too much risk. The deceptive accounting now available for stock options are bad, not just for the company, but the country. Zero costing allows the CEO to suck too much compensation from out of the company and allows the company to sucker investors into the company. Stock options waste capital, stunt growth and destroy jobs.

Respectfully Submitted,

The Coalition to Stop Stock Options

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510–6075

December 5, 2003

The Honorable Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Chairman Herz,

Thank you for testifying before the Subcommittee on Securities and Investment of the Committee on Banking, Housing, Urban Affairs at the hearing on November 12, concerning the "Financial Accounting Standards Board and Small Business Growth." I understand the demands of your schedule and appreciated your presence at the hearing.

As you know and heard at the hearing, small businesses play a vital role in the health of the U.S. economy. It is essential that small businesses' concerns are brought forth and considered by the Financial Accounting Standards Board ("FASB") as part of its decision making process. Accordingly, I applaud the commitment that you made at the hearing to establish a Small Firm Advisory Committee to advise the FASB on small business issues. I am confident that a Small Firm Advisory Committee representing a broad cross section of the small business community will accomplish this objective.

An example of a similar successful relationship is the Small Firm Advisory Board (SFAB) created by the NASD. The NASD created the SFAB so that small broker/dealer firms have a voice in matters effecting them. NASD rules are reviewed by the SFAB before they are submitted to the NASD Board of Directors. After review by the Board, all rule proposals go through the NASD public comment process before being submitted to the SEC for an additional public comment process. Both the NASD and the SEC must review all the comments prior to any NASD rule proposal becomes final. The SFAB viewpoint is essential in making sure that small broker/dealer firms are adequately represented.

With respect to the proposed FASB Small Firm Advisory Committee, I strongly believe that all draft statements and interpretations prior to issuance by the FASB for public comment and that these comments will receive thoughtful consideration by the FASB. There also should be collaboration between the Small Firm Advisory Committee and the Financial Accounting

The Honorable Robert H. Herz
December 5, 2003
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Standards Advisory Committee (FASAC) to ensure that the FASAC understands and takes into consideration the small firms' concerns. In addition, the comments of the Small Firm Advisory Committee should be made publicly available through the FASB website. I believe that the establishment of the Small Firm Advisory Committee could be accomplished in time for the June 2004 FASAC meeting.

Thank you again for testifying before the Subcommittee. I look forward to working with you and the rest of the FASB on accounting and small business issues.

Sincerely,

Michael B. Enzi

Michael B. Enzi
Chairman
Subcommittee on Securities
and Investment

cc:
The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

THE WALL STREET JOURNAL. ONLINE

April 19, 2004 4:04 p.m. EDT

FASB Chairman Calls For Investors To Speak Up On Options

By LINGLING WEI
April 19, 2004 4:04 p.m.

Of DOW JONES NEWSWIRES

NEW YORK -- Financial Accounting Standards Board Chairman Robert Herz, acknowledging as "very well organized" the high-tech lobby against expensing stock options, called for investors to "make your views known."

During an investor conference call Monday hosted by Glass Lewis & Co., a San Francisco-based institutional investor advisory firm, Herz said "there definitely are risks" that the board's efforts to require stock-option expensing could be thwarted by congressional intervention.

"While we believe we will go through, I know one thing I can't control is Congress," Herz said, a remark reminiscent of FASB's failure a decade ago to require companies to treat employee options as a business expense. In the face of congressional pressure as well as strong opposition from corporations, the board compromised on the current rule that encourages expensing but doesn't require it. Companies do have to disclose the options expense in their financial footnotes.

Under the new standard FASB proposed at the end of March, companies will have to count the value of options against earnings, starting next year. The proposal is open to public comment until the end of June; FASB expects to put a final rule in place by year-end.

However, amid the heavy tech lobbying, two bills associated with stock options have been introduced in Congress. One would deter FASB from making the accounting change for three years, while the other would limit the expensing requirement to a company's five highest-paid executives.

"All we can do is to continue to march along with our (standard-setting) due process," Herz said. In the meantime, he said, investors and analysts, the very beneficiaries of the proposed rule change, should also make sure that "you make your views known to people in Washington."

A recent survey conducted by Broadgate Consultants found that the vast majority of the 302 portfolio managers and analysts polled support the FASB expensing proposal, saying the rule change will improve financial transparency and corporate governance.

There has also been a growing movement among shareholders of tech companies to demand stock-option expensing. Among them: Texas Instruments Inc. (TXN), PeopleSoft Inc. (PSFT), Hewlett-Packard Co. (HPQ) and Apple Computer Inc. (AAPL).

Among those who participated in Monday's discussion with investors were Sir David Tweedie, chairman of the International Accounting Standards Board, the European counterpart to the FASB, and Lynn E. Turner, former chief accountant of the Securities and Exchange Commission and now managing director of research at Glass Lewis.

IASB already has passed a rule on stock-option expensing. The two boards have been working together since 2002, with the ultimate goal of having a single set of high-quality accounting standards worldwide. "We would be horrified" if Congress stepped in and blocked FASB's reform efforts on stock options, Tweedie said.

The chairmen of both boards have acknowledged that the biggest challenge for them to achieve convergence has so far come from heavy business lobbying for politicians' intervention in accounting standards. On the IASB part, the European Commission has threatened to reject its two standards on financial instruments, thanks to heavy lobbying by European banks and insurers.

During the call, in addition to calling for more involvement from investors in the standard-setting process, both chairmen also went through some details about how exactly to account for the compensation expense.

They noted that currently there is a slight difference between the IASB rule and the FASB proposal on how to account for the income-tax benefits derived from stock options. Tweedie, noting the willingness from both sides to solve the difference, said "hopefully next year, we both will have exactly the same standard."

-By Lingling Wei, Dow Jones Newswires; 201-938-2089; Lingling.Wei@dowjones.com

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NVCA
National Venture Capital Association

April 30, 2004

Honorable Carl Levin
United States Senate
269 Russell Senate Office Building
Washington, DC 20510

Dear Senator Levin,

At the hearing Wednesday, April 28, 2004, you requested that I consider the issue of whether treating employee stock options as an expense at the date of exercise would be appropriate. As a preliminary matter, I think it is important to clarify that exercise date accounting for financial reporting purposes will not result in financial accounting that is identical to the income tax consequences that flow from employee stock options. A company receives a tax deduction when, and if, the employee exercises the option and only if the employee recognizes taxable income. For example, if the option is an incentive stock option within the meaning of the Internal Revenue Code, and the employee satisfies that holding period requirement, then the employee does not recognize income and the corporation never gets a deduction, regardless of the difference between the stock price at the date of exercise and the exercise price. As a result, exercise date accounting for financial accounting purposes will not be identical to the tax treatment afforded employee stock options.

That being said, we also think that there are additional issues with exercise date accounting. To account for an option only when it is exercised is problematic because the item that is provided, the option, no longer exists at exercise. We are unaware of any item that is accounted for only when it is disposed of. FASB specifically considered whether exercise date accounting should apply when they deliberated the current standard, FAS 123, and rejected this approach. We agree with the FASB that exercise date accounting is not appropriate.

As I mentioned in my testimony, small businesses and private companies also have significant issues with fair value accounting and what FASB has termed "intrinsic value" accounting for stock options. Of course, we do not believe that stock options represent an expense at all, but putting that aside, and also putting aside all of the valuation issues that I discussed in my testimony, the costs that would be imposed on small business and private companies under FASB's Exposure Draft would dwarf any perceived benefit.

Thank you for your consideration of my testimony and I look forward to continued deliberation on this important matter.

Sincerely,

Mark Heesen
President, NVCA

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THE ANALYST'S ACCOUNTING OBSERVER

Jack T. Ciesielski, CPA, CFA

Volume 12, No. 6 & 7 *May 27,2003*

The Pendulum Swings Again: 2002 Option Compensation

The most hackneyed accounting subject in the financial press is stock option compensation and the limitless debate over the proper treatment for it. It's no wonder the topic became so over-exposed, though: the option compensation pendulum arced almost forever in one direction while the tech/telecom-industry miracles of the 1990's unfolded. In the 2000's many of those miracle firms simply folded, and no great intellectual leap is required to make the connection between option compensation and reckless managerial behavior. "Alignment with shareholders" provided the alibi.

For the first time since the option footnote information has been made available in 1996, the pendulum has started to swing in the opposite direction. Perhaps due to the bad publicity generated by Enron and its fellow scoundrels in the Class of '02, compensation denominated in options wasn't awarded nearly as frequently in 2002. Another push on the pendulum: in 2001, only two companies treated stock option compensation as a legitimate expense in earnings; now, ninety-three companies plan to do the same.

Until everyone accounts for similar transactions in similar fashion, however, 95 out of 500 just won't do. This report unifies the stock option accounting for the S&P 500, and presents trends in the way stock options are being handled by companies in the post-Enron era. One prediction: 2003 will see the first decline in stock option compensation expense.

I. A Turning Tide - For Now

Year after year, for as long as the footnote information provided by FASB Statement No. 123 has been around, companies have been routinely chosen to report earnings without recording the effects of option compensation. Only two companies in the S&P 500 - **Boeing** and **Winn-Dixie** - voluntarily chose to record the expense of compensation paid in stock options. The routine has been broken in 2002: since **Coca-Cola's** blockbuster July announcement that it would elect expense recognition, throngs of companies joined the bandwagon. Including Coke, ninety-three of the companies are in the S&P 500.

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Research Assistants:	
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Brian Neuner	Scott Thompson
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Administration:	Brenda Rappold

The Analyst's Accounting Observer *Volume 12, No. 6&7* *May 27, 2003*

The Pendulum Swings Again: 2002 Option Compensation

As the FASB takes on the momentous task of examining the accounting for stock option compensation, it's as important as ever to see where it's been going in the past year. Examining the "expense in a footnote" information provided by Statement No. 123 presents the full cost earnings story that you haven't seen in the quarterly reporting throughout all of 2002. The information for the S&P 500 is examined in this report, with some surprising trends and findings.

Highlights:

• ***Option compensation expense increased again in 2003, but not quite as dramatically as usual.*** The after-tax option compensation expense approached $48 billion in 2002, up another $4 billion from 2001. The rate of increase slowed; the expense grew only 9% in 2002 compared to 34% in 2001.

• ***Earnings were overstated 23% due to the non-recognition of option compensation expense.*** In 2001, the overstatement was 25%. See the table below for the overstatement by sector.

Overstatement As % Of "Fully-Costed" Earnings

	2002	2001	2000	1999	1998	1997	1996	1995
Consumer Discretionary	182%	34%	8%	6%	3%	3%	2%	1%
Consumer Staples	5%	6%	5%	4%	5%	3%	2%	1%
Energy	6%	3%	2%	4%	5%	2%	1%	0%
Financials	7%	6%	3%	4%	3%	2%	1%	1%
Health Care	10%	10%	10%	8%	6%	3%	2%	2%
Industrials	8%	7%	5%	5%	4%	5%	2%	1%
Information Technology	51%	24%	24%	14%	13%	9%	5%	3%
Materials	22%	15%	9%	8%	2%	5%	2%	1%
Telecom	15%	NA	8%	5%	3%	3%	1%	1%
Utilities	27%	3%	4%	2%	1%	1%	0%	0%
Aggregate S&P 500	**23%**	**25%**	**8%**	**6%**	**5%**	**4%**	**2%**	**1%**

• ***Significant declines in option compensation expense appeared.*** Partly due to lower fair values of option grants in 2002 and 2001, and lower amounts of grants in 2002, 180 companies showed declining stock compensation expense - an increase of 51% from 2001.

• ***Grants dropped significantly in 2002. They were off 19% from 2001 levels.*** That combined with lower relative fair values on the grants, make for a high probability of lower option compensation expense in 2003.

• ***Concentration of grants to the top executives varied widely in 2002.*** The most broad-based grants were in the technology sector, while grants in the utilities sector were more concentrated in the hands of the top five executives.

• ***Estimates of option fair values contained some conflicting principles.*** Some firms shortened the expected lives of new options granted, some lowered their volatility estimates, and some did both, which doesn't make perfect sense in terms of the Black-Scholes model used so frequently by companies.

• ***A new trend: companies started to adopt expense recognition as an accounting policy.*** That was the good news. The bad news was that option compensation wasn't much of an issue for most of the firms, and the majority of them chose the least robust method of implementing the change.

• ***Underwater options are a big fact of life.*** At the end of April, over half of the S&P 500 companies - 263 companies in all - with option exercise prices for their outstanding options at year-end with lower than the current stock price.

• ***Tax benefits from option exercises decreased in 2002.*** They amounted to $11.3 billion, down from $22.6 billion as opportunities for profitable exercises became more elusive.

• ***"Alignment with shareholders" remains a pipe dream.*** A greater percentage of firms with low "options overhang" in their capital structure outperformed the firms with high "options overhang" for the five year period ending in 2002.

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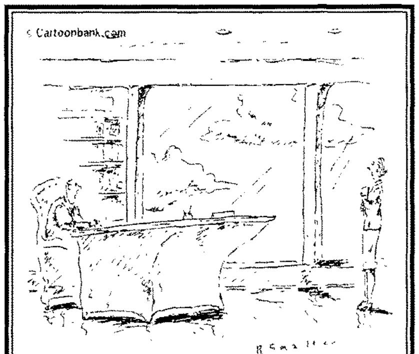


"I have the six figures, the stock options, and the limo, but where are the letters from grateful schoolchildren?"

First appeared in the New Yorker. Cartoonbank.com 2003

<u>Recognizing these costs remains an election - for now.</u> The FASB and the IASB have both reached tentative conclusions on separate stock compensation projects that such costs are calculable and must be recorded in earnings, possibly as soon as 2004 for *all* companies. That has not gone down gently with Silicon Valley types, who have been playing their political cards as vigorously as in 1994 when they handily outmaneuvered the FASB in Congress.

They've enlisted allies such as Senator Mike Enzi (Wyoming - R.) and Senator Barbara Boxer (California - D.) into holding a Senate roundtable on the importance of stock options in the American economy - a roundtable totally stacked against the "expense treatment" point of view.

They're playing other cards. They've invoked the argument that expense recognition of option compensation will end "partnership capitalism" between workers, stockholders and management, to whip employees into a populist frenzy so they'll lobby their congressmen for action.

They're playing the "death by delay" strategy by goading representatives David Dreier (California - R.) and Anna Eshoo (California - D.) to introduce a bill forbidding the FASB to issue new standards on option accounting while requiring the SEC to enact "enhanced disclosures" for three years - and to perform a study on their effect afterwards.

They're trying cast doubt on the veracity of any expense figures tied to option compensation expense by trashing the Black-Scholes option pricing model - perhaps most famously in an April 22 Wall Street Journal editorial by **Intel Corporation's** CEO Craig Barrett, where he proclaimed that the "kind of right" results from using the Black-Scholes option pricing model to calculate fair values aren't good enough. He then proceeded over the edge of the cliff by sanctimoniously invoking the Sarbanes-Oxley Act: if the Act requires CEOs to attest to the accuracy, how can they comply with the law if they certify Black-Scholes "guesstimates?" Perhaps Mr. Barrett should huddle with his general counsel: he already certified last year's financial statements which include Black-Scholes-estimated values for options and warrants held as assets. Apparently his distaste for such "guesstimates" doesn't extend to options unrelated to compensation.

<u>No matter where the FASB and IASB go with their projects, there won't be absolute certainty present in any value estimate for options at the date of grant.</u> Companies and investors need to grow up when faced with that fact: the truth is that with the possible exception of cash, precious little else in the financial statements is an absolutely precise figure. They're all riddled with estimates, some good, some not so good.

Option compensation accounting reform should provide a window into how companies pay executives and employees with only one particular medium of exchange. Consider this: any information about compensation is extremely rare in income statement reporting. Labor is one the most critical inputs to production, but outside of a few industries, how often do you see "compensation & benefits" as a line item in the income statement? Not very often. The same visceral corporate reaction would occur if an accounting proposal required companies to disclose the cash cost of compensation. Perhaps the FASB and the IASB should require improved disclosure of <u>cash compensation as well as recognition of stock-based compensation</u>; investors would then be able to effectively assess the management of those resources.

For now, let's concentrate on what we <u>can</u> know: how stock option compensation was handled in the S&P 500 during the past year and ever since the Statement No. 123 footnote disclosures have been available. The table below summarizes the big picture.

S&P 500 Reported Earnings & Unrecorded Compensation

($ in billions)	2002	2001	2000	1999	1998	1997	1996	1995	5Yr. CAGR	3 Yr. CAGR
Earnings as reported	$253.8	$219.8	$436.7	$373.6	$316.3	$285.4	$262.2	$215 7	*-2.3%*	*-12.1%*
Unrecorded compensation	47.6	43.6	32.5	21.1	13.8	9.8	4.8	2 2	*37.2%*	*31.2%*
Net earnings	$206.2	$176 2	$404.2	$352.5	$302.5	$275.6	$257.4	$213 5	*-5.6%*	*-16.4%*
Earnings overstatement	**23%**	**25%**	**8%**	**6%**	**5%**	**4%**	**2%**	**1%**		
YTY change in:										
Earnings as reported	***15%***	*-50%*	*17%*	*18%*	*11%*	*9%*	*22%*			
Unrecorded compensation	***9%***	*34%*	*54%*	*53%*	*41%*	*104%*	*118%*			
Net earnings	***17%***	*-56%*	*15%*	*17%*	*10%*	*7%*	*21%*			

The computational ground rules: "earnings as reported" is shorthand for earnings available to common shareholders, on a diluted basis, from continuing operations. It's figured as the diluted EPS times the number of diluted shares outstanding. It includes all costs in earnings: no "pro forma-ing" of figures for one-time charges. The unrecorded compensation is the amount of the stock compensation that would have been recognized had all of the S&P 500 firms employed Statement No. 123 accounting. Finally, net earnings are called that because they really <u>are</u> net of all expenses incurred to produce them. "Net earnings" for companies that do not apply Statement No. 123 accounting beyond footnote disclosures is a misnomer: they're not net. They're presenting earnings without important inputs.

Another ground rule: the information in 2002 is slightly incomplete due to the fact that at the time of this writing, six component companies had not yet reported their 2002 results. They are ***Allegheny Energy, Cummins Engine, Federal Home Loan Mortgage Company, King Pharmaceuticals, Qwest,*** *and* ***Symbol Technologies.***

As you can see, reported earnings may pause now and then (look at 2001) but stock option compensation never rests. It might be starting to abate however: 2002 was the first year of single-digit growth in option compensation since the information became available.

<u>Bear in mind there's a built-in bias when looking at the growth pattern because Statement No. 123 expense information is only related to options granted after December 15, 1994 - even though there were plenty in existence at the time.</u> The fair value of those options is to be spread over the period of expected service by the employees receiving them. The expense figures for 1995 will reflect only the option compensation expense for options granted that year and the portion of the service period included in 1995; some would be deferred into 1996, which would include some expense from 1996 grants and some carried over from 1995. Note that neither year would include any expense related to service provided under grants made in 1994 and earlier. The pro forma compensation expense will be understated until all of the older options "roll off" through exercise, forfeiture or expiration. It's less of a problem in recent years.

<u>The trend may look the same but there's a curious undercurrent.</u> The overall rate of stock compensation increase is slowing, but it actually declined in 2002 for a number of companies. Be aware: this is *not* due to the fact that some companies announced adoption of Statement No. 123 expense treatment in 2002. The footnote data

Options Really *Were* Popular In 1995...

	Award	1995	1996	1997	1998	1999
1995	$25,000	$5,000	$5,000	$5,000	$5,000	$5,000
1996	25,000	–	5,000	5,000	5,000	5,000
1997	25,000	–	–	5,000	5,000	5,000
1998	25,000	–	–	–	5,000	5,000
1999	25,000	–	–	–	–	5,000
		$5,000	$10,000	$15,000	$20,000	$25,000

It just doesn't look that way because of the phase-in of the disclosures. Example: Awards of $25 million worth of stock options per year, with expected service period of five years, will result in increasing expense recognized each year until fully loaded expense is reached. It's like depreciation expense for companies that continually buy equipment, taking five years until the annual figure shows the full effect.

The Pendulum Slows Down

	2002	2001	2000	1999	1998	1997	1996
Increases	$9.4	$14.5	$13.7	$8.6	$5.6	$5.2	$3.2
Decreases	(5.4)	(3.4)	(2.4)	(1.5)	(1.2)	(0.4)	(0.5)
Option compensation change	$4.0	$11.1	$11.4	$7.1	$4.4	$4.8	$2.7
# of companies:							
Increases	303	368	370	372	365	355	345
No change	17	13	29	44	57	83	118
Decreases	180	119	101	84	78	62	37
	500	500	500	500	500	500	500
YTY Change in # of companies:							
Increases	***-18%***	***-1%***	***-1%***	***2%***	***3%***	***3%***	
Decreases	***51%***	***18%***	***20%***	***8%***	***26%***	***68%***	

2002 saw a couple of strange phenomenons, one of them being that some companies promised to start recognizing stock option compensation in their earnings. Less noticed, yet still surprising, was the fact that the growth of "hidden" stock compensation slowed dramatically in 2002 - and over 50% more companies than last year experienced decreases in stock compensation. The expense pendulum may well have reached the end of its arc in 2002.

provides completely level information for all companies whether or not they were on Statement No. 123 accounting or APB Opinion No. 25 accounting. The table above summarizes some of the surprising currents just below the surface of the figures.

There are a couple of reasons why the option expense didn't grow so rapidly as in the past, the most obvious one being that perhaps they're just not the emolument of choice in a bear market. We'll see confirming evidence of that in the following section on grant information: suffice it to say for now that option *grants* dropped significantly in 2002. Ditto for the fair values of the options, which one would expect in a bear market: the current stock price is an input into the Black-Scholes option pricing model used by so many companies. The lower the stock price at grant date, the lower the estimated option fair values; in turn, the compensation expense based on the fair value estimates is lower than it would be if stock prices were at bull market highs. The decline in both grants and the fair values of grants had a braking effect on 2002 stock option compensation expense. Below, a look at how much the 2002 stock option compensation expense increased or decreased by sector.

Ups & Downs: Directions The Expense Went In 2002

Decreasers:	#	*$ billions*	*Increasers:*	#	*$ billions*
Information Technology	29	($2 0)	Information Technology	47	$3 8
Financials	30	(0.9)	Financials	51	2.4
Telecom Services	6	(0 8)	Telecom Services	6	0 4
Consumer Discretionary	30	(0.6)	Consumer Discretionary	56	0.6
Consumer Staples	11	(0 4)	Consumer Staples	23	0 4
Energy	12	(0.2)	Energy	11	0.1
Health Care	11	(0 2)	Health Care	32	0 8
Industrials	25	(0.1)	Industrials	40	0.4
Materials	12	(0 1)	Materials	19	0 3
Utilities	14	(0 1)	Utilities	18	0.3
Total	**180**	**($5.4)**	**Total**	**303**	**$9.4**

At left, the number of companies in each S&P sector showing dollar decreases or increases in 2002 stock option compensation compared to 2001. At first it may seem surprising that the tech sector showed such significant declines, but since so much of the total stock compensation is tied up in that one sector, it's reasonable to expect that any overall trends in the S&P 500 will have some tie-in to technology.

The appetite for compensation is insatiable, however, and it would be highly unlikely that the decline in option grants was because managers in 2002 were suddenly feeling ashamed of previous piggish behavior. Without any information about cash compensation, one can't tell if their appetites were satisfied through more conventional pay methods instead of continuing option grants. Disclosures about restricted stock were scarce, so it was hard to tell if an increase in expense tied to restricted stock grants offset the decline in option compensation expense.

The table on the next page shows 49 companies with estimated decreases in option compensation expense from 2001 in excess of $20 million.

Option Compensation Decreasers Of 2002

($ in millions)		2002	2001	2000	1999	1998	1997	1996
Yahoo!	Information Technology	($400)	($584)	$1,118	$307	$45	$4	$4
AOL Time Warner	Consumer Discretionary	(377)	795	155	412	(78)	117	17
Ciena Corp	Information Technology	(364)	216	71	12	20	4	1
AT&T	Telecom	(321)	151	247	59	64	(8)	98
Cisco Systems	Information Technology	(238)	611	551	299	141	65	60
Coca-Cola	Consumer Staples	(224)	25	25	24	49	25	25
Agilent Technologies	Information Technology	(192)	222	244	19	8	11	0
Bank One	Financials	(176)	73	79	(1)	35	11	25
Apple Computer	Information Technology	(142)	85	220	28	4	11	27
Exxon Mobil	Energy	(142)	(4)	141	(1)	34	57	50
Merrill Lynch & Co.	Financials	(138)	545	56	191	44	28	16
Oracle	Information Technology	(131)	167	242	28	74	46	30
Morgan Stanley	Financials	(126)	(122)	145	130	24	152	(107)
U S Bancorp	Financials	(98)	99	(1)	68	30	22	8
Altria Group	Consumer Staples	(93)	85	64	(26)	25	(1)	49
Sprint PCS Group	Telecom	(86)	(53)	187	74	0	0	0
Applied Micro Circuits	Information Technology	(85)	217	24	4	1	0	0
American Int'l Group	Financials	(80)	80	0	6	31	15	0
Pfizer	Health Care	(73)	(255)	323	251	124	66	64
Alcoa	Materials	(72)	(24)	64	103	(10)	6	6
Providian	Financials	(64)	8	30	20	10	3	0
Corning	Information Technology	(58)	266	39	16	0	16	(2)
Sprint Corp FON Group	Telecom	(53)	(153)	161	133	0	0	0
Avaya	Information Technology	(44)	(18)	42	23	29	0	0
Gap	Consumer Discretionary	(42)	(46)	25	23	48	15	12
Comverse Technology	Information Technology	(37)	99	39	19	15	9	3
Limited Brands	Consumer Discretionary	(37)	4	4	4	4	8	3
Gateway	Information Technology	(36)	(224)	185	63	26	14	6
Motorola	Information Technology	(35)	174	114	(80)	57	0	67
Chevron Texaco Corp	Energy	(32)	42	(75)	72	92	(46)	(7)
Xilinx	Information Technology	(31)	42	66	10	6	21	0
Comerica	Financials	(31)	20	2	11	6	3	3
Torchmark	Financials	(31)	33	(7)	14	(21)	17	3
Charles Schwab	Financials	(30)	56	44	28	28	12	0
Interpublic	Consumer Discretionary	(28)	29	1	18	10	1	3
Federal Homeloan Mtg	Financials	(28)	7	7	0	0	7	0
Rockwell Automation	Industrials	(28)	9	(57)	64	0	13	4
Ebay	Consumer Discretionary	(26)	39	111	63	0	0	0
Honeywell	Industrials	(24)	17	8	16	0	26	6
American Power Conversion	Industrials	(24)	13	11	12	10	4	0
Symbol Technologies	Information Technology	(23)	4	5	7	2	4	0
IMS Health	Health Care	(22)	(54)	54	18	3	20	7
Delphi	Consumer Discretionary	(22)	(12)	35	44	0	0	0
Anadarko Petroleum	Energy	(22)	4	29	(2)	5	2	5
Guidant	Health Care	(21)	23	18	18	39	9	7
Novell	Information Technology	(21)	23	27	34	11	21	7
Computer Sciences	Information Technology	(21)	17	2	2	7	6	3
Regions Fin'l Corp	Financials	(20)	23	4	(2)	7	(2)	2
General Motors	Consumer Discretionary	(20)	(31)	52	21	44	70	23

Notice that the drop in option compensation expense was new for most of these companies

<u>Don't think the decreases related only to 2002 actions.</u> If you picked up only one lesson from the "ramp-up" description on page 4, it should be that any one year's option compensation expense is an amalgam of current and previous years' grants and their fair values. Likewise, the decreases in the above table are an amalgam of grant activity in past and current years, and the fair values of the grants in past and previous years. We'll look at those issues separately later, but one preview: both grants and the estimated fair values declined in a big way in 2002.

The following three tables address the earnings overstatement by sector due to unstated stock option compensation expense. First, the plain vanilla figures: as-reported GAAP earnings.

S&P 500 "As Reported" Income from Continuing Operations

($ in billions)	2002	2001	2000	1999	1998	1997	1996	1995
Consumer Discretionary	$2.2	$19.7	$50.0	$51.9	$58.5	$38.3	$34.5	$32.4
Consumer Staples	42.6	36.3	34.6	32.2	27.2	29.2	26.7	22.5
Energy	11.7	30.4	35.8	15.3	10.4	21.4	16.5	8.9
Financials	107.1	86.3	107.5	102.3	76.5	70.6	59.7	44.6
Health Care	48.2	42.9	37.2	33.6	29.5	27.5	25.4	20.1
Industrials	38.5	39.7	46.3	39.4	34.9	28.7	29.6	24.6
Information Technology	(21.2)	(65.1)	70.4	49.3	33.6	31.3	26.2	20.9
Materials	5.0	5.3	11.5	8.6	9.1	9.9	11.5	15.3
Telecom	16.0	2.4	31.5	23.8	22.5	14.9	17.8	13.1
Utilities	3.7	21.9	11.9	17.2	14.1	13.6	14.3	13.3
Total	**$253.8**	**$219.8**	**$436.7**	**$373.6**	**$316.3**	**$285.4**	**$262.2**	**$215.7**
YTY Change	***15%***	***-50%***	***17%***	***18%***	***11%***	***9%***	***22%***	--

Not a bad year: a nice rebound from the 2001's misery and in the same profitability league as in the salad days of the 1990's. Next, a look at how that picture changes if *all* costs of production are included in earnings.

"Pro Forma" Income from Continuing Operations

($ in billions)	2002	2001	2000	1999	1998	1997	1996	1995
Consumer Discretionary	($2.7)	$14.7	$46.3	$49.0	$56.8	$37.1	$33.9	$32.1
Consumer Staples	40.6	34.3	33.0	31.0	26.0	28.5	26.3	22.4
Energy	11.0	29.6	35.0	14.7	9.9	20.9	16.3	8.9
Financials	100.6	81.2	104.1	98.2	74.0	69.0	59.1	44.3
Health Care	43.6	39.0	33.7	31.1	27.8	26.7	24.8	19.8
Industrials	35.6	37.0	44.0	37.5	33.5	27.3	29.1	24.3
Information Technology	(43.5)	(85.6)	56.7	43.2	29.7	28.8	24.9	20.4
Materials	4.1	4.6	10.6	7.9	8.9	9.4	11.2	15.1
Telecom	13.9	0.0	29.3	22.7	21.9	14.5	17.6	13.1
Utilities	3.0	21.4	11.5	16.9	14.0	13.5	14.3	13.3
Total	**$206.2**	**$176.2**	**$404.2**	**$352.2**	**$302.5**	**$275.7**	**$257.5**	**$213.7**
YTY Change	***17%***	***-56%***	***15%***	***17%***	***10%***	***7%***	***21%***	--

The earnings trend is pretty much intact but what a change in the figures: over the eight year stretch, earnings were overstated by $175.4 billion - the sum total of the after-tax stock compensation. See the table below.

A History: Unrecorded After-tax Stock Option Compensation Expense

($ in billions)	2002	2001	2000	1999	1998	1997	1996	1995
Consumer Discretionary	$4.9	$5.0	$3.7	$2.9	$1.7	$1.2	$0.6	$0.3
Consumer Staples	2.0	2.0	1.6	1.2	1.2	0.7	0.5	0.2
Energy	0.7	0.8	0.8	0.6	0.5	0.5	0.2	0.0
Financials	6.5	5.1	3.4	4.0	2.5	1.6	0.7	0.3
Health Care	4.5	3.9	3.5	2.5	1.7	0.9	0.6	0.3
Industrials	2.9	2.6	2.2	1.8	1.4	1.4	0.5	0.3
Information Technology	22.3	20.5	13.7	6.1	3.9	2.5	1.3	0.5
Materials	0.9	0.7	0.9	0.6	0.2	0.5	0.2	0.2
Telecom	2.1	2.4	2.2	1.1	0.6	0.4	0.2	0.1
Utilities	0.8	0.6	0.5	0.3	0.1	0.1	0.0	0.0
Total	**$47.6**	**$43.6**	**$32.5**	**$21.1**	**$13.8**	**$9.8**	**$4.8**	**$2.2**
YTY Change	***9%***	***34%***	***54%***	***53%***	***41%***	***104%***	***118%***	--
Cumulative unrecorded expense	***$175.4***	***$127.8***	***$84.2***	***$51.7***	***$30.6***	***$16.8***	***$7.0***	***$2.2***

One can make numerous scary inferences about the $175 billion of unrecorded expense. The least subtle inference is that if earnings were so overstated, then the stock market was also overvalued by, say, a multiple of twenty or more times that much in any single year. It's a frequent argument made about the effect of non-recognition of stock option expense - but stocks aren't always valued at an iron-clad multiple applied equally to every component of earnings. There's no way to prove it absolutely wrong or right, of course, but it's hard to refute the fact that some companies certainly got more credit than they deserved at some point in the last eight years because their earnings were untainted by these costs. One counterpoint to the argument that stocks were overvalued because of this missing expense: during the pro forma reporting craze of the late 1990's, one cannot help but believe these expenses would have been "pro forma-ed away" by willing market participants simply because they were non-cash items. Market fluffiness might have occurred anyway.

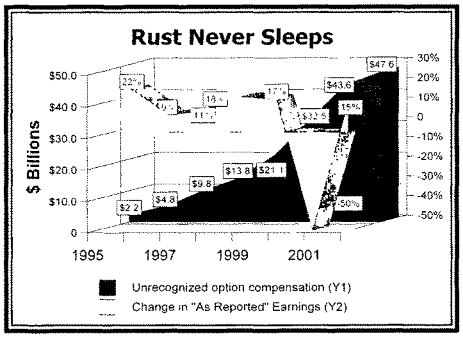
Or maybe not. The only certainty is that investors were handicapped in setting fair prices in fair stock markets because they were denied relevant information. The Silicon Valley defenders of financial statement opaqueness bleat about the innovation produced by stock option incentives and the joys of home ownership provided by option exercises for those who otherwise could never afford homes, and how expensing options will bring all of those social positives to an end. Even if they really believe that would happen, those social engineers never consider other social positives that affect more than just their constituents: namely, the benefits to an entire economy when capital is allocated to where it is served best. That's accomplished when the capital market participants have access to financial statements that let them to make decisions based on all available facts. That couldn't happen in the late 1990's.

One more table demonstrates a little differently how unrecorded stock option affected the different S&P 500 sectors. The table below shows the swing in profitability between "as reported" earnings and "fully-expensed" earnings. Would the stock market performance of each sector been *exactly* the same each year if the full-expense figures had been reported? A lockstep decline in market value might not have occurred for each company based on the additional expense reported - but the full expense amount would have certainly conveyed new information to investors about the way management treated themselves as well as how the boards of directors treated management. Perhaps more likely than simple lockstep changes in share value, this information might have provoked institutional investors to take more critical views of relationships among board members and managements.

Percentage Swing: "As Reported" Earnings To "Fully-Costed" Earnings

#		2002	2001	2000	1999	1998	1997	1996	1995
88	Consumer Discretionary	-223%	-25%	-7%	-6%	-3%	-3%	-2%	-1%
35	Consumer Staples	-5%	-6%	-5%	-4%	-4%	-2%	-1%	-0%
23	Energy	-6%	-3%	-2%	-4%	-5%	-2%	-1%	0%
82	Financials	-6%	-6%	-3%	-4%	-3%	-2%	-1%	-1%
46	Health Care	-10%	-9%	-9%	-7%	-6%	-3%	-2%	-1%
67	Industrials	-8%	-7%	-5%	-5%	-4%	-5%	-2%	-1%
76	Information Technology	-105%	-31%	-19%	-12%	-12%	-8%	-5%	-2%
34	Materials	-18%	-13%	-8%	-8%	-2%	-5%	-3%	-1%
12	Telecom	-13%	-100%	-7%	-5%	-3%	-3%	-1%	0%
37	Utilities	-19%	-2%	-3%	-2%	-1%	-1%	0%	0%
500	***Aggregate S&P 500***	***-19%***	***-20%***	***-7%***	***-6%***	***-4%***	***-3%***	***-2%***	***-1%***

The shaded portion of the table represents the early years of the SFAS No. 123 information As described on page 4, they're "light" on stock option compensation because the phase-in tied to only the options issued after 12/15/94. When did expense became fully charged? It can't be told for sure: it's related to the vesting period of options issued. Given that the customary vesting period is three years at many companies, the "loading period" could have been complete in 1997 if firms made grants at the beginning of 1995, or complete at the end of 1998 for options granted at the end of 1995. Even during this likely "option expense lite" period, the information technology sector was still the one that would have seen the biggest swing in earnings had they reported earnings more honestly - a trend that continued right to this day.



Earnings ebb and flow, but stock option compensation never seems to take a rest.

The chart at left shows the year to year percentage change in the "as reported" earnings of the S&P 500, plotted alongside the annual after-tax amount of unrecognized stock option compensation. Earnings took a breather in 2001 and rebounded a bit in 2002, but the growth in stock option compensation remained relentless.

The compensation expense will likely decrease in 2003. The reason: the fair value of the amount of awards has been decreasing, partly because fewer options were granted this year and because the fair values attached to grants work out to lower amounts in a bear market. If grants and fair values follow the same pattern in 2003, the first down year could occur for stock option compensation expense.

Stock Option Compensation Expense (After-tax) & YTY Change

($ in billions)	2002		2001		2000		1999		1998		1997		1996		1995
Utilities	$0.8	33%	$0.6	20%	$0.5	67%	$0.3	200%	$0.1	0%	$0.1	NA	$0.0	NA	$0.0
Materials	0.9	29%	0.7	-22%	0.9	50%	0.6	200%	0.2	-60%	0.5	150%	0.2	0%	0.2
Financials	6.5	28%	5.1	50%	3.4	-15%	4.0	60%	2.5	56%	1.6	129%	0.7	133%	0.3
Health Care	4.5	15%	3.9	11%	3.5	40%	2.5	47%	1.7	89%	0.9	50%	0.6	100%	0.3
Industrials	2.9	12%	2.6	18%	2.2	22%	1.8	29%	1.4	0%	1.4	180%	0.5	67%	0.3
Info Technology	22.3	9%	20.5	50%	13.7	125%	6.1	56%	3.9	56%	2.5	92%	1.3	160%	0.5
Consumer Staples	2.0	0%	2.0	25%	1.6	33%	1.2	0%	1.2	71%	0.7	40%	0.5	150%	0.2
Consumer Discretionary	4.9	-2%	5.0	35%	3.7	28%	2.9	71%	1.7	42%	1.2	100%	0.6	100%	0.3
Energy	0.7	-13%	0.8	0%	0.8	33%	0.6	20%	0.5	0%	0.5	150%	0.2	NA	0.0
Telecom	2.1	-13%	2.4	9%	2.2	100%	1.1	83%	0.6	50%	0.4	100%	0.2	100%	0.1
Aggregate S&P 500	**$47.6**	**9%**	**$43.6**	**34%**	**$32.5**	**54%**	**$21.1**	**53%**	**$13.8**	**41%**	**$9.8**	**104%**	**$4.8**	**118%**	**$2.2**

The table above summarizes the after-tax stock compensation expense for the ten different S&P 500 sectors; it's sorted in decreasing order of percentage change compared to 2001. It might seem surprising that the biggest percentage increases in stock option compensation took place in the utilities, materials and financial sectors, but in the grand scheme of things, those were increases on pretty low previous year amounts; naturally, the percentage change will be high. When it comes to sheer dollar bulk of buried compensation, the information technology sector has no match. In fact, it takes almost all the other sectors combined to match the dollar amount of stock compensation of the tech sector: it accounts for 46% of the total.

Overstatement As % Of "Fully-Costed" Earnings

	2002	2001	2000	1999	1998	1997	1996	1995
Consumer Discretionary	182%	34%	8%	6%	3%	3%	2%	1%
Consumer Staples	5%	6%	5%	4%	5%	3%	2%	1%
Energy	6%	3%	2%	4%	5%	2%	1%	0%
Financials	7%	6%	3%	4%	3%	2%	1%	1%
Health Care	10%	10%	10%	8%	6%	3%	2%	2%
Industrials	8%	7%	5%	5%	4%	5%	2%	1%
Information Technology	51%	24%	24%	14%	13%	9%	5%	3%
Materials	22%	15%	9%	8%	2%	5%	2%	1%
Telecom	15%	NA	8%	5%	3%	3%	1%	1%
Utilities	27%	3%	4%	2%	1%	1%	0%	0%
Aggregate S&P 500	**23%**	**25%**	**8%**	**6%**	**5%**	**4%**	**2%**	**1%**

If a firm misses its earnings by a penny, the stock wilts - and a penny is not always a material percentage of most firms' EPS.

When it comes to option compensation, firms' earnings are way off on a percentage basis - with no discipline from the stock market to make managers mind.

(Shaded portions of the table are years where expense figures were still ramping up for grants.)

A perennial question when the Statement No. 123 information becomes available: which firms would have been unprofitable had expense recognition been required? The table below shows those firms.

Earners To Losers Of 2002, Continuing Operations

Firm	Sector	2002 % EPS Overstmt.	EPS As Reported	Pro Forma
Network Appliance	Information Technology	8000%	$0 01	($0 79)
Robert Half	Industrials	1800%	0.01	(0.17)
Veritas Software	Information Technology	514%	0 14	(0 58)
Yahoo!	Information Technology	450%	0.18	(0.63)
Apple Computer	Information Technology	356%	0 18	(0 46)
Novellus Systems	Information Technology	313%	0 15	(0 32)
Analog Devices	Information Technology	218%	0 28	(0 33)
Nvidia Corporation	Information Technology	193%	0.54	(0.50)
Citrix Systems	Information Technology	167%	0 52	(0 35)
Mercury Interactive	Information Technology	166%	0.74	(0.49)
Charles Schwab	Financials	157%	0 07	(0 04)
Autodesk	Information Technology	146%	0.28	(0.13)
Intuit	Information Technology	128%	0 32	-0 09
Applied Materials	Information Technology	119%	0.16	-0.03

*Aside from being an ineffective way of informing investors about the costs of production in a firm, the pro forma information required by Statement No. 123 is geared only to net income, not income from continuing operations - usually more interesting to investors. A firm is not required to disclose the amount of pro forma stock compensation expense tied to discontinued operations. That was the case with **Intuit.** The pro forma effects were displayed only for net income - but some of it may have been allocated to discontinued operations. One can only deduce the net amount of option compensation and figure that it went to continuing operations - a safer guess than figuring all of it went to discontinued operations.*

The issue of "earners to losers" is a bit overdramatized in the press at times: most of the companies in the table above were barely profitable to begin with, so stock option compensation would surely be the last straw. Of the fourteen companies in the table, twelve of them were in the technology sector. (Notice a pattern yet? Hmmm....)

At the same time, if firms had to record the cost, would managers have managed differently to avoid red ink? Would they have worked harder at finding price increases, or cutting out unprofitable projects or trimming overhead expenses? One would hope so - but not facing up to all of the costs of production leads to managerial sloth. Make no mistake about it - option costs are a factor of production. Try taking them away from employees and see if they stick around. Ignoring their value, though, is ignoring a big, secularly growing fixed cost - and you don't manage fixed costs by hiding them.

In the table below, thirty-five companies in the S&P 500 not quite in the "earners to losers" category. These firms' earnings were overstated by 100% or more by suppressing the cost of stock option compensation.

Firms With Overstatement Of 100% Or Greater (Continuing Operations)

Firm	2002 % EPS Overstatement	EPS As Reported	Pro Forma
PeopleSoft	5600%	$0 57	$0 01
Siebel Systems	2738%	(0.08)	(2 27)
Adobe Systems	2533%	0 79	0 03
Altera	2200%	0.23	0 01
Jabil Circuit	1600%	0 17	0 01
Boise Cascade	600%	(0 03)	(0.21)
PerkinElmer	567%	(0 03)	(0 20) *
Cisco Systems	400%	0.25	0.05
EMC	340%	(0 05)	(0 22)
Ebay	305%	0.85	0.21
Symantec Corp	275%	(0 20)	(0 75)
Electronic Arts	255%	0.71	0.20
Calpine	250%	0 14	0 04 *
ACE Limited	217%	0.19	0 06
Ford	200%	0 15	0 05 *
Scientific-Atlanta	200%	0.66	0 22
Andrew Corp	200%	0 12	0 04 *
Maxim Integrated	192%	0.73	0.25

Firm	2002 % EPS Overstatement	EPS As Reported	Pro Forma
Qualcomm	175%	$0 44	$0 16
PMC-Sierra, Inc	158%	(0.38)	(0.98)
Tektronix	154%	0 33	0 13 *
Applera - Applied Bio Grp.	152%	0.78	0.31
KLA-Tencor	134%	1 10	0 47
National Semiconductor	129%	(0.69)	(1.58)
Comverse Technology	116%	(0 69)	(1 49)
J P. Morgan Chase	116%	0.80	0 37
Texas Instruments	115%	(0 20)	(0 43)
Allergan	113%	0.49	0 23 *
Sun Microsystems	111%	(0 18)	(0 38)
Parametric Technology	108%	(0.36)	(0.75)
MeadWestVaco Corp	100%	(0 01)	(0 02) *
Novell	100%	(0 28)	(0.56) *
American Electric Power	100%	0 06	0 03 *
Xerox	100%	0 10	0.00 *
Xilinx	100%	(0 34)	(0 68)

* *indicates discontinued operations. See Intuit, discussed above.*

Coke opened Pandora's box in July 2002 when they announced that they would start recording option compensation expense; the imitators swarmed. There are 93 born-again compensation recorders in the S&P 500, which sounds impressive - but there's less than meets the eye. First of all, there are three methods of adoption available to those companies adopting Statement No. 123 accounting - and they have different effects on earnings presentation. In brief, an adopting firm can choose to implement the new method only for new options granted - leading to the ramping-up "phase-in" problem discussed earlier. (Call it "adoption lite," or the pure prospective treatment.) A firm can choose to recognize the remaining expense tied to unvested options and new options, which will create a break in comparability with previous years which contain no option compensation expense. (Call it just a fully-loaded prospective treatment, or simply "unvested.") Lastly, a firm can go with the second approach *and* restate prior years to keep things comparable. (Call it the full-strength approach.) Out of the 93 new adopters, 81 of them are choosing "adoption lite." Six have chosen the unvested, fully-loaded prospctive treatment, four have selected the full-strength treatment, and the remainder did not disclose their choice in their 2002 annual reports. All else equal, it could take years to see meaningful stock option compensation expense information in earnings.

There's even less here than meets the eye. The median overstatement of 2002 earnings per share in the S&P 500 companies was 7%. The median overstatement for the new adopters was 4%, meaning that the most severely distorted presentations of earnings will not be improving any time in the near future, as long as recognition of stock compensation expense remains an elective.

Below, the new adopters, their choice of implementation method, and their 2002 overstatement.

Firms Committing To Recognize Option Compensation

Firm	Method	% Over	Firm	Method	% Over	Firm	Method	% Over
Calpine	Lite	250%	Computer Associates	Lite	7%	KeyCorp	Lite	2%
Ford	Unvested	200%	FleetBoston Financial	Lite	7%	General Electric	Lite	2%
J.P. Morgan Chase	Lite	116%	Centex	Lite	7%	Emerson Electric	Lite	2%
Lincoln National	Full	58%	Lowe's Companies	Lite	7%	Paccar	Lite	2%
Travelers P&C	Lite	53%	Home Depot	Lite	7%	PPL	Lite	2%
AT&T	Lite	45%	CSX	Lite	6%	Comerica	Lite	2%
Merrill Lynch & Co.	NA	44%	Entergy	Lite	6%	Fannie Mae	Lite	2%
Cendant	Lite	37%	AES Corp	Lite	6%	Pulte Homes	Lite	2%
Chubb	Unvested	33%	Mellon Financial Corp.	Lite	6%	United Parcel Service	Lite	2%
Dow Chemical	Lite	23%	Hartford Finl	Lite	6%	Washington Mutual	Lite	2%
Sprint - PCS Group	Lite	21%	State Street	Lite	5%	Johnson Controls	Lite	2%
Goldman Sachs	Lite	21%	Safeco	Lite	5%	Wachovia	Lite	2%
XL Capital	Lite	16%	Moody's	Lite	5%	Target	Lite	2%
Temple Inland	Lite	16%	Bank Of America	Lite	5%	Suntrust Banks	Lite	2%
American Express	Lite	14%	Bear Stearns	Lite	5%	Pinnacle West Capital	Lite	1%
John Hancock	Lite	13%	National City Corp	Lite	4%	Transocean	Lite	1%
General Motors	Lite	12%	SBC Comm.	Full	4%	Principal Financial Gp	Lite	1%
Costco	Lite	12%	Allstate	Lite	4%	Genuine Parts	Lite	1%
Apartmt. Inv. & Mgmt.	Lite	11%	Prudential Financial	Lite	4%	Equity Office Propts.	Lite	1%
Unocal	Lite	11%	BellSouth	Full	4%	American Int'l Gp	Lite	1%
Verizon	Lite	11%	May Dept Stores	Lite	4%	Bank One	Lite	1%
Morgan Stanley	Lite	10%	MetLife	Lite	4%	Wal Mart Stores	Full	1%
Rohm & Haas	Lite	10%	AMBAC Financial	Lite	3%	CMS Energy	Lite	0%
Du Pont	Lite	10%	Anadarko Petroleum	Lite	3%	Cinergy	Lite	0%
Conoco Phillips	Lite	10%	Ashland	Unvested	3%	Coca-Cola	Unvested	0%
Jones Apparel	Lite	9%	Leggett & Platt	Lite	3%	Sunoco	Unvested	0%
Sprint - FON Grp.	Lite	9%	Citigroup	Lite	3%	MBIA	Unvested	0%
Tupperware	Lite	8%	Visteon	Lite	3%	Simon Property Gp	Lite	0%
Bank Of New York	Lite	8%	PNC Fin'l	Lite	3%	USX-Marathon	Lite	0%
Block, H&R	NA	8%	Masco	Lite	2%	Plum Creek Timber	Lite	0%
Cooper Industries	Lite	7%	Keyspan	Lite	2%	Ameren	Lite	0%

Expensing: Only If It's Easy

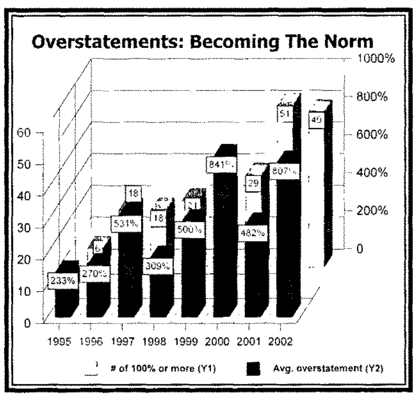
	Total	Granted	Unvested	Full
Consumer Discretionary	**16**	14	1	1
Consumer Staples	**1**	0	1	0
Energy	**7**	5	1	0
Financials	**40**	36	3	1
Health Care	**0**	0	0	0
Industrials	**9**	8	0	0
Information Technology	**1**	1	0	0
Materials	**4**	4	0	0
Telecom	**6**	4	0	2
Utilities	**9**	9	0	0
	93	**81**	**6**	**4**

Don't be too quick to congratulate firms that choose to treat stock option compensation as an expense. Not many of them will be making significant changes.

For the most part, the commitment to elect expense treatment of options by the S&P 500 members looks more like a public relations ploy than an attempt at improving financial reporting.

As the table on the previous page shows, most of the firms have below average option compensation expense - and at the table at left shows, most of them are choosing the lightweight method for adopting such a policy, with expense recognition effective only for newly-issued options instead of existing unvested instruments.

The fact that the least affected firms are the ones that volunteered to treat option compensation as a legitimate expense only underscores the fact that standards need to be standard for all companies - and that when it comes to applying standards, volunteerism makes for lousy results in financial reporting.



The chart at left shows the number of companies with overstated earnings per share of 100% or more ever since the Statement No. 123 information became available. It also shows the average earnings overstatement of those companies.

As has been mentioned several times in this report, one should not be misled by the trend in the early years: it's not that firms were issuing fewer options in those years before 1999, it's just that the option compensation expense didn't yet reflect the vesting of all options issued since the start of the pro forma information.

Also do not be misled by the decline in the number of overstaters in 2002; while it looks like that there were marginally fewer than last year (49 versus 51), the figures do not include six firms that had not yet reported. Inclusion of the data for those six could have tipped the balance the other way.

If firms overstated earnings by means of say, recognizing revenue early or understating depreciation, would investors stand for it? Of course not. But when it comes to understating compensation costs, they practically accept is as a norm. Call it defining deviancy down.

* *

Without grants, there would be no stock compensation expense to analyze. Let's take a look at what happened in the way of grants in the past year.

II. Giving Away The Store: Grant Activity

Investors can kick themselves: option grants are compensation cocaine for executives, and shareholders let them cultivate their addiction. Managements have been hooked on them for years, always serenading investors with the ingratiating tune of "alignment of management with shareholder interests." Investors, always eager to believe, willingly went along with the newest option plan presented. There's another reason investors have always been agreeable to increases in grants. Because they're often obsessed only on whether or not earnings beat estimates, investors tend to miss things that happen below the surface of the financial statements. A gradual ceding of their ownership to management is one of those things that is not apparent from an intensive study of "beating estimates."

If only investors cared to look deeper into the annual report footnotes, they'd find bountiful information about the way options were dispensed. Obviously, it would be far more timely to get such information on a quarterly basis, but one can still learn much from the annual information. In this section, we'll look at the grant activity through a couple of different prisms: actual quantity of options granted, concentration of grants at executive levels and the value of the options granted.

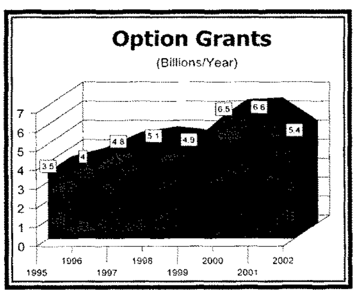
Actual quantity of options granted

Start with the actual options granted. The table below shows the distribution of the grants by sector for the last eight years. For each year, the left column is the amount of options granted; the right column is the percent change from the previous year.

Option Grants/YTY % Change

	2002		2001		2000		1999		1998		1997		1996		1995
Information Technology	2.0	-31%	2.9	0%	2.9	61%	1.8	-18%	2.2	0%	2.2	16%	1.9	36%	1.4
Financials	1.0	0%	1.0	11%	0.9	12%	0.8	14%	0.7	17%	0.6	20%	0.5	67%	0.3
Consumer Discretionary	0.7	-13%	0.8	14%	0.7	17%	0.6	-14%	0.7	17%	0.6	20%	0.5	-29%	0.7
Health Care	0.5	0%	0.5	0%	0.5	0%	0.5	25%	0.4	0%	0.4	33%	0.3	0%	0.3
Industrials	0.4	0%	0.4	0%	0.4	0%	0.4	0%	0.4	0%	0.4	33%	0.3	0%	0.3
Consumer Staples	0.3	0%	0.3	0%	0.3	0%	0.3	50%	0.2	0%	0.2	0%	0.2	0%	0.2
Telecom	0.2	-33%	0.3	-25%	0.4	100%	0.2	0%	0.2	0%	0.2	100%	0.1	0%	0.1
Energy	0.1	0%	0.1	0%	0.1	0%	0.1	0%	0.1	0%	0.1	0%	0.1	0%	0.1
Materials	0.1	0%	0.1	-50%	0.2	100%	0.1	0%	0.1	0%	0.1	0%	0.1	0%	0.1
Utilities	0.1	-50%	0.2	100%	0.1	0%	0.1	0%	0.1	--	0.0	--	0.0	--	0.0
Aggregate	**5.4**	-18%	**6.6**	2%	**6.5**	33%	**4.9**	-4%	**5.1**	6%	**4.8**	20%	**4.0**	14%	**3.5**

After cresting in 2001, the number of options granted tumbled in 2002 - dropping 18% compared to the 2001's peak. The tech sector, always in the lead when it came to getting more options, was in the lead when it came to taking less (at least in sheer number of options foregone.) Don't be deluded into thinking that firms were simply being more conscientious or more chaste in dispensing options in 2002 than in past years. Option compensation was hot simply because the market was hot, and options produced immediate wealth in the go-go years of 1995 through early 2000. When markets turned cold, starting with the bursting of the internet bubble in 2000, the payoff to stock options seemed a lot less assured and managements demanded fewer. "Alignment with shareholder interests" be damned when the going gets tough.



Fading chances of a fat quick payoff may be one reason option popularity diminished - but there are other possible explanations. First, firms may actually believe that required expense treatment is on the way through the FASB and IASB efforts. If they do believe so (despite the obstruction efforts of

Silicon Valley), they might be concerned that huge amounts of overhanging options will crimp future earnings if accounting transition requirements require them to recognize expense related to unvested options. A second possibility: by showing more restraint in issuing options, firms opposing "expensing" efforts might be able to point to their current good behavior as a reason why no reform is needed. A third possibility for diminishing option popularity might be that other forms of compensation - cash and restricted stock - might be increasing in popularity. The problem is that there's no way to track down increases in cash compensation between years, and only sketchy disclosure of restricted stock was found in this survey. A final possibility: there are still six firms not included in the figures, which might skew things. (Given the size of the firms, not much distortion is likely.)

The New Options Chastity: Grant Changes From 2001

(Options in millions)	Option Decreases	# Firms	Option Increases	# Firms
Consumer Discretionary	218 5	44	103 3	44
Consumer Staples	90 6	20	69 0	15
Energy	14 3	11	33 2	11
Financials	258.5	44	204.5	36
Health Care	73 3	23	81 2	20
Industrials	90.4	32	112.5	34
Information Technology	1,127 8	45	222 9	30
Materials	20 6	15	30.1	18
Telecom	79 5	7	9 3	4
Utilities	89.9	14	34.9	19
Totals	2,063.3	255	900.9	231
Total average options issued, 1999 - 2001 *(millions)*			5,979.1	
Total issued in 2002 / % Change			5,440.5	-9%

What's wrong with this picture? The number of firms giving fewer options in 2002 compared to 2001 outnumbered the ones increasing the option grants - a counterintuitive trend. Even the technology sector, historically the most vocal proponent of stock option issuance, decreased the number issued in 2002.

Note: the number of companies does not total 500 because fourteen companies either did not provide sufficient information or had no change. It's possible that firms give a really big grant only once every few years, but even taking that into account, the aggregate options issued were still down in 2002.

Below, a summary of 54 companies in the S&P 500 with share decreases in option grants of at least 4 million compared to 2001, and a percentage decrease of 40% or more. Notice the many technology firms.

2002 Options Dieters

(Grants in millions)	2002 Grant	2001 Grant	2002 Grant Chg.	2002 Grant Chg. %		2002 Grant	2001 Grant	2002 Grant Chg.	2002 Grant Chg. %
Lucent	14 0	347 6	(333.6)	-96%	Baxter Int'l	11 8	23 9	(12.0)	-50%
Microsoft	41.0	224.0	(183.0)	-82%	Marriott	1.4	13.4	(12.0)	-90%
Siebel Systems	5 9	110 8	(105.0)	-95%	Alcoa	17 3	28 9	(11.6)	-40%
Applied Materials	8 8	93 0	(84.2)	-91%	PG&E Corp.	0.2	11.4	(11.2)	-98%
AOL Time Warner	115 0	193 3	(78.2)	-41%	Clear Channel	0 3	11 4	(11.1)	-98%
J.P. Morgan Chase	85 8	162.9	(77.1)	-47%	LSI Logic	8 4	18.9	(10.5)	-55%
Charles Schwab	26 0	68 0	(42.0)	-62%	Symantec Corp	8 5	18 3	(9 9)	-54%
SBC Communications	36.0	76.0	(40 0)	-53%	Delphi	12.4	21.9	(9.5)	-44%
U S Bancorp	29 7	65 1	(35.4)	-54%	Dominion Resources	3 1	12 2	(9.0)	-74%
Altria Group	3.3	35.6	(32.4)	-91%	Coca-Cola Enterprises	7.9	16.3	(8.4)	-51%
Novell	5 5	36 0	(30.5)	-85%	Kellogg	9 2	17 1	(7.9)	-46%
Yahoo!	32.6	60.3	(27.7)	-46%	Radioshack	1.5	9.4	(7.9)	-84%
El Paso Energy	3 4	28 3	(24.9)	-88%	Omnicom Group	2 3	9 3	(7.0)	-75%
Avaya	10.4	31.6	(21.2)	-67%	Nvidia Corporation	8.5	15 2	(6 6)	-44%
Gateway	15 1	35 1	(20.0)	-57%	Computer Associates	4 5	11 1	(6 6)	-60%
AES Corp.	1.1	21.2	(20.0)	-95%	Carnival	0.0	6.6	(6.6)	-100%
Sprint *FON Group*	24 2	43 8	(19 6)	-45%	Occidental	4 9	11 0	(6.1)	-56%
Guidant	1.2	20.7	(19.6)	-94%	PerkinElmer	3.3	9.3	(6.1)	-65%
Gap	14 2	30 5	(16 3)	-54%	Linear Technology	1 8	7 8	(6.0)	-77%
Capital One Financial	6.6	21.1	(14.5)	-69%	Regions Fin'l Corp.	3.9	9 6	(5.7)	-59%
Applied Micro Circuits	10 3	24 6	(14 3)	-58%	Southern Co	8 0	13 6	(5.6)	-41%
PMC-Sierra, Inc	0.7	14.8	(14.2)	-96%	Lowe's Companies	5 5	10.9	(5.3)	-49%
Sears	1 1	14 9	(13 9)	-93%	MetLife	7 3	12 3	(5.0)	-41%
Dynegy	2 3	15.8	(13.5)	-86%	Union Planters	4.3	9.1	(4.8)	-53%
Goldman Sachs Group	15 9	29 0	(13.1)	-45%	Burlington North S F	2 9	7 4	(4.6)	-61%
Lilly, Eli & Co.	14.1	26.9	(12.8)	-47%	Power-One	0.6	5.0	(4.4)	-88%
Honeywell	3 0	15 5	(12.5)	-81%	Watson Pharm	1 8	6 0	(4.2)	-70%

Not everybody went on an options diet. Relative to their three-year average of options granted, some firms still showed healthy increases in grants in 2002. Below, a look at 126 firms where the 2002 grants exceeded 20% of the three year average options granted. Why a three year average? Simply because firms may grant options on a cyclical basis, perhaps taking into account vesting provisions. Three years is a common vesting period, so it's used here as foundation for averaging.

Where 2002 Options Issuance Increased Relative To 3 Year Average Issuance

(Grants in millions)	2002 Grant	Avg. 1999-2001	% Incr.		2002 Grant	Avg. 1999-2001	% Incr.		2002 Grant	Avg. 1999-2001	% Incr.
Conoco Phillips	28.8	4.1	600%	Starwood	15.6	9.3	67%	Schlumberger	7.3	5.3	39%
Sysco	30.5	4.6	560%	Medtronic	19.0	11.3	67%	State Street	7.1	5.1	39%
Southwest Airlines	52.8	9.9	435%	Int'l Paper	11.9	7.1	67%	Allstate	8.5	6.1	39%
Safeco	3.3	0.8	326%	CVS	8.0	4.8	66%	Louisiana-Pacific	1.9	1.4	39%
Campbell Soup	15.2	3.8	301%	Thermo Electron	5.3	3.2	66%	Marsh & McLennan	21.0	15.4	37%
Kerr-McGee	2.5	0.7	260%	Bristol-Myers Squibb	40.1	24.3	65%	Veritas Software	25.9	19.0	36%
Williams Companies	15.8	4.6	246%	CenturyTel	2.0	1.2	64%	Baker Hughes	2.1	1.5	36%
American Greetings	5.3	1.5	244%	Electronic Data Sys	26.5	16.2	64%	Marshall & Ilsley	4.8	3.6	35%
Union Pacific	2.1	0.7	202%	Bank Of New York	14.4	8.9	62%	Navistar Int'l	1.8	1.3	35%
Compuware	31.4	10.7	194%	Johnson & Johnson	48.1	29.7	62%	Amsouth Bancorp	8.9	6.6	35%
Allegheny Technologies	3.1	1.1	177%	Tellabs	16.8	10.5	61%	Walt Disney	50.0	37.3	34%
Peoples Energy	0.6	0.2	172%	Transocean	2.2	1.4	57%	Pinnacle West Capital	0.6	0.5	34%
Apartment Invt. & Mgmt	2.1	0.8	165%	Comcast Corp.	16.6	10.9	52%	Paychex	2.2	1.7	33%
Delta Air Lines	8.5	3.2	163%	Ciena Corp	26.6	17.5	52%	Hilton Hotels	7.5	5.6	33%
Analog Devices	28.1	11.4	147%	Freeport McMoran	3.7	2.4	52%	Micron Technology	24.5	18.5	32%
Eastman Kodak	20.2	8.5	138%	Weyerhaeuser	3.0	2.0	51%	Nabors Industries	5.5	4.2	32%
Ford	50.6	22.0	130%	XL Capital	3.5	2.3	51%	Corning	26.9	20.3	32%
BJ Services	4.1	1.8	123%	Procter & Gamble	25.0	16.6	51%	Boise Cascade	2.0	1.6	31%
Northrop Grumman	2.3	1.0	118%	Bank Of America	85.8	56.9	51%	ACE Limited	5.2	4.0	30%
Textron	5.1	2.4	117%	Air Products & Chem	5.5	3.6	50%	FPL Group	1.7	1.3	29%
Sanmina	16.8	7.9	113%	Coors, Adolf	1.9	1.3	49%	American Standard	2.3	1.8	29%
Genuine Parts	3.1	1.5	109%	Wells Fargo & Co	41.8	28.1	49%	Target	6.1	4.7	29%
Du Pont	24.6	11.9	107%	Wyeth	32.9	22.3	48%	EOG Resources	1.8	1.4	28%
USX-U.S. Steel Group	1.8	0.9	106%	Dover	2.1	1.5	48%	Allied Waste Inds	4.6	3.6	28%
Dow Jones	2.5	1.2	104%	CMS Energy	1.5	1.0	47%	Equity Office Prop.	6.5	5.1	28%
Cooper Industries	2.8	1.4	101%	Tribune Co	13.6	9.3	47%	Rohm & Haas	4.5	3.5	27%
Motorola	100.1	52.0	92%	Devon Energy	2.8	1.9	46%	Caterpillar	8.1	6.4	27%
Circuit City Group	4.4	2.3	92%	Northern Trust	4.5	3.1	45%	SLM Corporation	9.1	7.3	25%
Tyco	60.0	31.5	91%	Int'l Game Technology	1.6	1.1	44%	Wrigley, William Jr	2.0	1.6	25%
Moody's	3.8	2.0	90%	Computer Sciences	4.1	2.9	44%	TJX Companies	11.4	9.1	25%
Washington Mutual	20.9	11.4	83%	Eastman Chemical	1.9	1.3	43%	American Int'l Group	5.7	4.6	25%
North Fork Bancorp	1.2	0.7	83%	Teco Energy	1.8	1.3	42%	Harrah's	2.9	2.3	24%
Qualcomm	26.5	14.7	81%	General Motors	22.3	15.7	42%	Sigma-Aldrich	1.1	0.9	24%
Solectron	26.1	14.5	80%	Becton, Dickinson	5.5	3.8	42%	Comerica	3.2	2.6	24%
Kroger	14.5	8.1	80%	Family Dollar Stores	1.5	1.0	42%	Ebay	16.9	13.6	24%
NiSource	2.2	1.2	77%	Huntington Bancshares	5.5	3.9	41%	Biogen	4.0	3.2	23%
Home Depot	31.7	18.1	75%	Jabil Circuit	4.4	3.1	41%	Abbott Labs	24.7	20.2	22%
Unisys	13.9	7.9	75%	Viacom	22.5	15.9	41%	Broadcom	40.7	33.6	21%
Wal Mart Stores	15.3	8.8	73%	Franklin Resources	4.2	3.0	40%	Applera (App Bio)	9.2	7.6	21%
Parker Hannifin	2.1	1.2	72%	General Mills	14.6	10.4	40%	MBNA	20.7	17.1	21%
Comverse	15.9	9.3	71%	IBM	60.0	42.9	40%	Tiffany & Company	2.2	1.8	21%
Calpine	9.0	5.3	69%	Exelon	3.9	2.8	40%	Wendy's Int'l	3.5	2.9	21%

Note that a three year average makes for a pretty gentle comparison: because options issuance had been rising over the last eight years, using a longer averaging period would have made for a lower benchmark - and make for a more dramatic contrast against the current options issuances.

Concentration of Grants at Executive Levels

One of the traditional rationales for stock option compensation, aside from the "alignment" angle, is that broad-based options programs will motivate employees to work harder - and for less cash, which would be recorded as compensation expense. Some managers hope to create a virtuous circle whereby they convince enough employees to prefer options over cash, lowering recorded cash compensation costs and in turn, improving earnings. The circle would continue when the stock market gives credit for those rising earnings, raising the stock price and making options more valuable - and hooking employees more deeply on the options cocaine.

That's the theory, anyway. Obviously, it hasn't worked too well in practice for the last few years. The inquiring analyst or investor ought to wonder just how much the employees share in option grants in the first place. In the S&P 500, there were 456 firms with 2002 grants to the top officers, as displayed in their proxy statements; the totals for these recipients were compared to the total grants made for the firm to measure the concentration of the grants. The degree to which the plans were "broad-based" depended on what one means by "broad-based;" it's a term that means something different to everyone. A worker might think a broad-based plan awards 95% of an option grant to rank-and-file employees; an exec might consider 50% of a grant for workers to be broad-based.

2002 Officer Grants Distribution

% To Top Officers:	Number of Firms	% of Total	Cumulative % of Total
10%	146	32%	*32%*
20%	160	35%	*67%*
30%	72	16%	*83%*
40%	32	7%	*90%*
50%	21	5%	*95%*
60%	8	2%	*96%*
70%	8	2%	*98%*
80%	6	2%	*99%*
90%	1	0%	*99%*
100%	2	0%	*100%*
	456	**100%**	

No attempt is made here to define what is or is not "broad-based;" the reader is left to make his or her own judgments. Findings are presented here in such a way as to help make those judgments. Look at the table at left: the percentage of a total company's grant going to officers in 2002 is displayed in increments of 10% in the shaded area on the left. The number of firms in a particular percentage range is in the next column, followed by the portion of the total each range represents. For instance, 146 of the firms awarded 10% or less of the total grant to top officers, representing 32% of the total firms. Another 160 firms awarded from 10% up to 20% of the total grant to top management, or 35% of all firms. Thus, 67% of the firms awarded less than 20% of total option grants to top management. If you think that 20% is broad-based you might be happy; if you think that's too narrow, it gets worse. The inverse is that one-third of the firms (150 of them) gave more than 20% of grants to the top officers - stretching the definition of "broad-based."

Don't be intimidated by the table below: it's the same distribution as above, but describes which sectors are awarding options to top officers at a given level. For example, there are 150 companies awarding 20% or more of total options awards to the top five officers - and 27 of them were in the consumer discretionary sector, 9 were in the consumer staples sector, and so on.

Distribution Of Executive Concentration In Grants, By Sector

	Total Cos.	Concentration Up to <= 10%		>10%		>20%		>30%		>40%		>50%	
Consumer Discretionary	**86**	28	33%	58	67%	27	31%	16	19%	10	12%	4	5%
Consumer Staples	**33**	8	24%	25	76%	9	27%	5	15%	2	6%	1	3%
Energy	**19**	3	16%	16	84%	11	58%	5	26%	3	16%	3	16%
Financials	**77**	31	40%	46	60%	25	32%	12	16%	8	10%	4	5%
Health Care	**42**	17	40%	25	60%	10	24%	3	7%	2	5%	1	2%
Industrials	**61**	16	26%	45	74%	22	36%	10	16%	4	7%	2	3%
Information Technology	**67**	28	42%	39	58%	13	19%	4	6%	2	3%	0	0%
Materials	**28**	5	18%	23	82%	14	50%	8	29%	4	14%	3	11%
Telecom	**11**	5	45%	6	55%	4	36%	3	27%	2	18%	1	9%
Utilities	**32**	5	15%	27	84%	15	47%	12	38%	9	28%	6	19%
	456	146		310		150		78		46		25	

Observe the shaded panel - the bold figures are the total companies making 2002 option grants to top five executives by sector. Still in the shaded panel, the next column is the number of companies making grants to the top five officers, followed by the percent of companies out of the total. Look at the telecom sector, outlined in the table: 5 of the 11 companies making grants to the top five executive officers awarded them less than 10% of the total options granted. That means 45% of the total companies gave most of the 2002 options to employees other than the top five. (That doesn't necessarily mean the options made it all the way down to the telephone operators. The breadth of the distribution cannot be fathomed from publicly available data. Ninety percent of the grants might well be given to the next eight executive officers.) The flip side: 55% of the telecom companies gave 10% or more of the 2002 grant to the top five officers. You can follow it in the next set of columns, which shows the number and percentage of companies in each sector awarding 10% or more of the 2002 grant to the top five officers. The columns continue the progression up to the 50% or more level.

Enough about how to look at the data - what does it show? There are a couple of surprises. First, notice that the utilities sector has more companies making "top heavy" grants (ones with a relatively higher proportion of grants going to the top five executive officers) than the other sectors. As you move to the right in the column pairs, the utilities sector consistently showed the highest proportion of companies giving the most options to top officers, relative to the total granted for 2002. (They're "boxed" in the table for easy spotting.) Second, the technology sector's claim that their option plans are well-dispersed within firms is validated here - 42% of the firms awarded less than 10% of the total 2002 grants to the top officers, and the proportion of the technology firms towards the right-hand side of the table - where the heavier officer grants appear - is slight.

The table on the facing page shows the 2002 grants, in total and to the top five executive officers, and their proportion of the total grants. It's ranked in descending order of concentration. (To keep the presentation presentable, the list was cut off at 78 companies with a 30% or greater level of executive concentration.)

Even if companies were to suddenly expense their option compensation, nothing will ever happen unless firms grant them to employees. Looking at the issuance of options can give you at least a rough idea of where option compensation expense will be heading in the future - as well as potential dilution of existing shareholders.

* *

Option Grants: What They're Worth

That's enough about the grant activity; onward to the fair values of the options granted in 2002. Knowing that grants of options decreased in 2002, and that prices of stocks were generally lower in 2002, there's only one direction that the fair values of granted options can head: down. (Keep in mind that firms use the Black-Scholes option pricing model to estimate the fair values of option grants. A lower stock price will result in a lower estimated option value, all else equal.) The table below confirms that guess in spades: the estimated fair value of the options granted in 2002 tumbled 39% compared to 2001, which in turn represented a decrease from 2000.

Option Grant Fair Values By Sector

	2002		2001		2000		1999		1998		1997		1996
Consumer Discretionary	$7.6	-40%	$12.7	53%	$8.3	-7%	$8.9	81%	$4.9	59%	$3.1	27%	$2.5
Consumer Staples	3.6	-13%	4.1	18%	3.5	10%	3.1	34%	2.3	49%	1.6	7%	1.5
Energy	1.0	-17%	1.2	-6%	1.2	20%	1.0	6%	1.0	21%	0.8	118%	0.4
Financials	10.9	-21%	13.8	30%	10.6	19%	8.9	62%	5.5	40%	3.9	106%	1.9
Health Care	7.7	-15%	9.0	24%	7.3	9%	6.7	48%	4.5	38%	3.3	79%	1.8
Industrials	5.3	4%	5.1	8%	4.8	13%	4.2	7%	3.9	21%	3.2	104%	1.6
Information Technology	20.8	-54%	45.5	-32%	66.6	213%	21.3	49%	14.3	53%	9.3	107%	4.5
Materials	1.2	9%	1.1	-36%	1.7	43%	1.2	100%	0.6	-15%	0.7	27%	0.6
Telecom	1.8	-56%	4.2	-42%	7.2	133%	3.1	98%	1.6	48%	1.0	90%	0.6
Utilities	0.8	-61%	1.9	108%	0.9	30%	0.7	149%	0.3	41%	0.2	95%	0.1
Total	$60.6	-39%	$98.6	-12%	$112.1	89%	$59.2	52%	$38.9	43%	$27.2	77%	$15.3

Executive Concentration In Option Compensation:2002 Grants

	Total Options Granted	Officer Option Grants	% To Officers		Total Options Granted	Officer Grants	% To Officers
Dynegy	2.28	2.180	95 4%	MBIA	1.85	0.780	42.1%
Rowan Companies	0 25	0 239	93.7%	McDermott Int'l	1 60	0 656	41.1%
Bemis	0.07	0.059	80.2%	Alltel	3.15	1.275	40.5%
HCR Manor Care	1 01	0 807	79.6%	Meredith	0 89	0 359	40.5%
Radioshack	1.52	1.202	79 3%	Peoples Energy	0.55	0.222	40.3%
AES Corp	1 14	0 875	76 5%	Union Planters	4 31	1 734	40.2%
PG&E Corp.	0.20	0.150	75 0%	Big Lots	1.93	0.775	40.1%
Jones Apparel Group	2 00	1 500	75.0%	Engelhard	1 35	0 533	39.4%
Honeywell	3 00	2.202	73 5%	Pinnacle West Capital	0.60	0.234	38.8%
Nicor	0 18	0 123	67 8%	FiServe	1 52	0 574	37.8%
Freeport McMoran	3.71	2.483	67 0%	Torchmark	1.17	0.438	37.6%
Sunoco	0 73	0 477	65 0%	Snap-On	0 86	0 324	37.5%
American Standard	2 27	1 445	63 7%	Archer Daniels Midland	2.63	0 987	37.5%
Constellation Energy Group	3 75	2 385	63 7%	Clorox	3 79	1 415	37.4%
Apartment Inv. & Mgmt.	2.07	1.315	63 5%	Center Point Energy	3.12	1 163	37.3%
Fannie Mae	0 87	0 549	63.4%	Equity Residential	2 26	0 843	37 3%
Marriott	1.40	0 885	63.2%	Crane	1.19	0.440	37.1%
Nabors Industries	5 50	3 280	59.7%	AMBAC Financial Group	1 54	0 560	36.3%
North Fork Bancorporation	1.22	0.692	56.6%	Anadarko Petroleum	1 40	0.500	35.7%
Circuit Cty Group	4 42	2 500	56 5%	MGIC Investments	0 82	0 290	35.5%
USX-U.S. Steel Group	1.83	1.004	55.0%	Great Lakes Chemical	0.90	0.308	34 2%
AFLAC	2 06	1 119	54.4%	Phelps Dodge	0 80	0 273	34.0%
Winn-Dixie Stores	0.55	0.288	52.8%	AT&T	15.18	5.020	33.1%
CenturyTel	1 98	1 003	50 6%	Bausch & Lomb	1 86	0 613	33.0%
Sempra Energy	3.44	1.742	50.6%	Paccar	0.66	0.218	33.0%
PPL	0 84	0 414	49 2%	Cooper Industries	2 81	0 914	32.6%
Lucent	13.95	6.844	49.0%	Int'l Game Technology	1.63	0.525	32.3%
Jefferson-Pilot	1 44	0 685	47.7%	Apple Computer	23 24	7 500	32.3%
Pulte Homes Inc	1.39	0.653	47.0%	Black & Decker	1.28	0.410	32.0%
Plum Creek Timber Co	0 48	0 225	46.9%	Centex	1 70	0 545	32.0%
KB Home	1.96	0.906	46.2%	Deluxe	1.25	0.396	31.6%
Gap	14 17	6 500	45 9%	CMS Energy	1 49	0 465	31.1%
Navistar Int'l	1.81	0.831	45.8%	Praxair	1.32	0.409	30.9%
Dillard's	2 31	1 050	45.4%	UST	0 75	0 232	30.8%
Thermo Electron	5 32	2 403	45 1%	Hasbro	4.76	1.460	30.7%
Altria Group	3 25	1 424	43.9%	Northrop Grumman	2 26	0 692	30 7%
Public Service Ent.	1.89	0.815	43.1%	Bed Bath & Beyond	3 44	1.050	30.5%
Zimmer Holdings	1 83	0 785	42.8%	Novell	5 45	1 652	30.3%
Louisiana-Pacific	1.89	0.796	42 2%	Noble Corp	1.63	0.490	30.1%

One postscript note on the above. Apple Computer's entire grant of 7 5 million options was for one person, CEO Steven Jobs In March 2003, Jobs cancelled all of his outstanding options and also received five million shares of restricted stock.

<u>We've explored the quantity side of option grants in enormous detail and provided perspective on the size of the quantities issued in different ways - but until you compare the *value* of what's being given to employees to the market capitalization of the firm, you really don't have any idea of the magnitude of wealth being turned over to executives and employees.</u> Purely for the sake of perspective, put aside whatever beef you may have with the Black-Scholes option pricing model and live with the fair values estimated by the firms in developing the Statement No. 123 footnote data. The table at the top of the next page compares the estimated fair value of the total options granted in 2002 to average market capitalization for the year - and even with the decline in the fair value of the

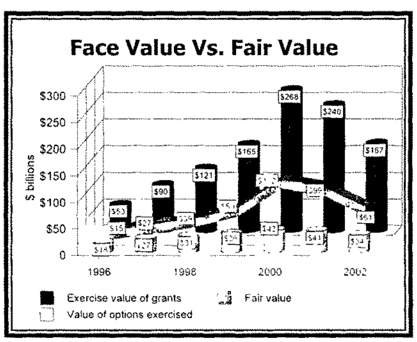
Comparison: Estimated Grant Fair Values To Market Capitalization

(Option grants in millions)	Options Granted	X	Fair Value at Grant Date	Total Grant Fair Value	Average 2002 Market Cap	Grant Value/ Market Cap
Broadcom	40.69		$9.33	$379.7	$4,712	*8%*
Applied Micro Circuits	10.27		13.36	137.2	1,806	*8%*
Travelers Property Casualty	78.80		5.84	460.2	6,484	*7%*
Compuware	31.38		5.09	159.7	2,776	*6%*
Nvidia Corporation	8.52		28.09	239.4	4,345	*6%*
Parametric Technology	18.46		3.25	60.0	1,086	*6%*
Peoplesoft	28.94		13.48	390.1	7,100	*6%*
Ciena Corp	26.62		4.88	129.9	2,458	*5%*

option grants, it's still surprising to see companies sending 5% or more of their capitalization to a favored group other than shareholders or creditors. Would these firms have tried to sell stock at the kinds of prices they gave to employees - would they have impressed anyone as smart sellers of their stock with their timing? Probably not - selling stock would be a *visible* financing transaction. Under the camouflage of non-expense treatment, however, they dispense the equity instruments freely.

Another fair value perspective: the total fair value of options granted in 2002 was $60 billion - about the same average market capitalization for the year as Bristol-Myers Squibb. If Bristol-Myers Squibb were to disappear all at once in a change of control, it would be noticed (maybe even expected). When $60 billion of spent market value is parsed among the companies in the S&P 500, no one can notice.

There's no end in sight to the debate about the value of options. There are three numbers representing option values embedded somewhere in the financial statements: zero, in the income statement for most firms; the estimated fair value, tucked into the footnotes; and the implied "exercise value" also buried in the footnotes. Exercise value is simply the exercise price of the options, usually the price of the stock at grant date. It represents what the company would receive if the options were exercised, and it's a fairly inarguable value: no assumptions about volatility or exercise, just a dollar amount of equity that might be turned over to a group of employees if they exercise their options. No argument is offered here that this is the "right" way to value options for expense recognition - just an attempt at putting another perspective on the size of the option grants. Looking at the exercise price of the options gives you an estimate of the upper limit of cash inflows if a) all options become profitable to the holders for exercise and b) all of them are exercised.



"Exercise value" also gives you an idea of the extent to which options transfer value to employees from shareholders at current prices. The chart at left shows that, consistent with declining stock prices and fewer options granted, the exercise value of all options issued is declining as well. It's still a substantial number: the face value of the options issued in 2002 totaled $167 billion, down 30% from 2001's level of $240 billion. That $167 billion of exercise value is worth 2% of the entire S&P 500 market capitalization at the end of April, 2003.

Notice also that the exercise of options was a lot harder to accomplish in 2002 than in previous years: only $34 billion of fresh equity came from option exercises, down $7 billion from 2001.

* *

Time to sum up a few observations and think about what it means for the future. We know that any one year's expense is an amalgam of fair values of current and prior option grants. We know that the fair value of grants has declined in 2002 and 2001 - partly because the quantity issued was lower in 2002, and partly because the fair values per option were lower (on average) in both years.

<u>Unless the fair value of options for 2003 zoom back to the levels seen in the boom years, the option compensation expense in 2003 will have nowhere to go but down - for the first time.</u> One can capture the relationship between fair value of grants and after-tax option compensation expense easily with a regression equation. Regress the fair value of grants from the current year, previous year and two previous years against the after-tax expense, and the result is an equation with pretty good explanatory power. See the box below.

Regression Results

	Option Compensation:		
	Actual	Predicted	Difference
1998	$13.8	$14.1	$-0.3
1999	21.1	20.7	0.4
2000	32.5	32.6	-0.1
2001	43.6	43.6	0.0
2002	47.6	47.6	0.0

A regression equation describes the relationship between the option grant fair values for the S&P 500 as an aggregate and the after-tax option compensation expense ever since 1998 - and it produces some fairly accurate results, as shown at left. (The equation is of the form:

$$y = 2.00849 + .118165\,(X_1) + .160395\,(X_2) + .202030\,(X_3)$$

The equation's R^2, a measure of how well the equation fits the relationship, is 99.97%. A measure of 1 is perfect.

Don't try to use this equation on a single company. The equation is based on the agglomeration of 500 companies attributes. To do the same thing for one specific company, you need to use only that company's data.

If the relationship described by the equation holds true for 2003, what does it mean for the option compensation expense? Two years of declining grant fair values should give us the expected direction, but the equation provides some answers for various levels of 2003 grants. If the fair value of grants bottomed out in 2002 and the same amount is awarded in 2003 - $60.6 billion - then the option compensation for 2003 should work out to $38.8 billion ("boxed" in the table), about $9 billion less than in 2002. If the relationship holds true, notice that the grant fair values would have to get back to levels higher than during the bubble years just to get back to the same after-tax expense seen in 2002.

Where Option Comp Might Go

Change From 2002 Grant Fair Value	Assumed 2003 Grant Fair Value	Estimated 2003 Option Comp Expense
-30	$30.6	$35.3
-20	40.6	36.4
-10	50.6	37.6
0	60.6	38.8
10	70.6	40.0
20	80.6	41.2
30	90.6	42.3
40	100.6	43.5
50	110.6	44.7
60	120.6	45.9
70	130.6	47.1
80	140.6	48.3

The upshot: unless 2003 sees option grants in magnitudes that would be incredible in light of all the attention now being turned on option plans, the "options diet" undertaken by many companies in 2002, coupled with the decline in fair values options granted in the last few years will assure that 2003's option compensation expense is lighter than 2002's. If the grants in 2003 are lower than in 2002, that augurs for a continued lightening expense trend in 2004 - meaning, at least in the aggregate, that any move to required option compensation expense recognition might not be nearly as dramatic as critics make it out to be.

III. Option Valuation

The Black-Scholes option pricing model has come in for its share of criticism as the new options war heats up. The model does have a lot of attributes that make its use less than perfect for valuing employee options: its robustness relates only to options with lives of nine months or less, it requires application of an estimated option life, and of course, there's the infamous "expected volatility" input. That's a very subjective figure possessing big impacts on the ultimate calculated values. There's no "right" volatility figure to plug into the Black-Scholes black-box, no magic number to pull out of a reference book. Try getting managements to discuss the *operating* prospects of their firm over a time frame longer than a year; the volatility input requires them to assess what might be the prospects of their firm's *stock* for up to ten years. If mandatory expense treatment becomes the norm, managements could be easily tempted to manage down their option compensation costs by shading the assumptions.[1]

How To Influence Black-Scholes Estimates

Input	Change in Input	Change in Option Value	Relationship
Exercise price	▲	▲	Direct
Current price	▲	▲	Direct
Expected life	▲	▲	Direct
Expected volatility	▲	▲	Direct
Expected dividends	▲	▼	Inverse
Risk-free rate	▲	▲	Direct

Some of the inputs to the Black-Scholes model are pretty much cut-and-dried, and verifiable. The exercise price and the current stock price are inarguable, as is the risk-free rate. Expected dividends can at least be compared to current dividends for reasonableness. Expected life is one that leaves a lot of room for "tailoring:" changes from past observed history can be rationalized in either direction. The same goes for expected volatility, in spades. Justification for what you believe will be the stock market treatment of a particular firm is simply conjecture.

While it's reasonable that firms have experienced lower fair values for options in 2002, one has to wonder if they might take the Boy Scout approach - "always prepared"- and start taking more aggressive approaches to some of the inputs to the Black-Scholes option pricing model just in case option compensation expense moves out of footnotes and into the income statement. The expected life of the options and the expected volatility factor are two of the most "rubbery" assumptions in the Black-Scholes model, so a look at some of the changes from last year's assumptions might be interesting. Changes in the assumptions are not conclusive by themselves: they might mean that firms are anticipating coming changes and starting to manage their costs, or it might simply mean they are being more critical of their past assumptions now that the stakes are being raised.

Shorter Lives By Sector

	# Firms	% of Total
Consumer Discretionary	9	16%
Consumer Staples	0	0%
Energy	3	5%
Financials	12	21%
Health Care	6	11%
Industrials	9	16%
Information Technology	11	19%
Materials	4	7%
Telecom	0	0%
Utilities	3	5%
	57	100%

Shortening the expected life of an option will decrease its value, with consequent lower option compensation expense. At left is the sector distribution of the 57 companies employing shorter option lives for 2002 grants than in 2001; the table on the next page shows the firms and their changes.

[1]For a discussion of various methods of valuing options and recording the expense, see Volume 11, No. 12, "Accounting Essentials: Compensation Paid In Stock Options." An example of how assumptions could easily be shaded to achieve desired results is on page 10.

2002 Expected Life Shorteners

	2002 Life	2001 Life	% Change		2002 Life	2001 Life	% Change
SLM Corporation	3.0	10.0	-70%	Newell Rubbermaid	6.9	9.0	-20%
Simon Property Group	6.0	10.0	-40%	Apollo Group	2.8	3.1	-10%
Comverse Technology	2.6	4.3	-40%	Delta Air Lines	6.7	7.5	-10%
Capital One Financial	5.0	8.5	-40%	Linear Technology	6.1	6.5	-10%
DTE Energy	6.0	10.0	-40%	Merck & Co.	5.7	6.7	-10%
Hercules	6.0	8.0	-30%	EOG Resources	5.3	6.0	-10%
Avery Dennison	7.0	10.0	-30%	National Semiconductor	5.1	5.7	-10%
Stanley Works	5.0	7.0	-30%	Deluxe	6.0	6.8	-10%
PMC-Sierra, Inc	2.1	3.0	-30%	Ball	4.8	5.3	-10%
Occidental	3.5	5.0	-30%	Deere	3.7	4.1	-10%
Goldman Sachs Group	5.0	7.0	-30%	Chubb	5.0	5.5	-10%
HCA	4.0	6.0	-30%	Office Depot	4.4	4.9	-10%
Consolidated Edison	6.0	8.0	-30%	Paychex	4.7	5.0	-10%
Electronic Data Systems	3.8	5.7	-30%	Charter One Financial	6.0	7.0	-10%
Zimmer Holdings	5.0	7.0	-30%	Power-One	5.8	6.5	-10%
Health Management Assoc	5.0	7.0	-30%	Meredith	6.5	7.3	-10%
Compuware	4.1	5.0	-20%	Ryder	6.0	7.0	-10%
Boston Scientific	5.0	6.0	-20%	Sigma-Aldrich	6.1	6.5	-10%
Home Depot	5.0	6.0	-20%	Apache	4.5	5.0	-10%
Cooper Tire & Rubber Co	4.3	5.5	-20%	American Express	4.5	5.0	-10%
Countrywide Financial Corp	4.2	5.0	-20%	Solectron	3.0	3.5	-10%
Danaher	8.0	10.0	-20%	Centex	7.0	8.0	-10%
Corning	5.0	6.0	-20%	Newmont Mining (Hldg Co.)	8.0	9.0	-10%
Federated Investors, Inc	6.7	8.3	-20%	Novellus Systems	3.1	3.3	-10%
FleetBoston Financial	4.0	5.0	-20%	Torchmark	4.5	4.8	-10%
Union Planters	3.9	5.1	-20%	Int'l Game Technology	3.5	3.9	-10%
Texas Instruments	5.0	6.0	-20%	United Health Group	4.5	4.8	-10%
Tellabs	5.9	7.0	-20%	Kinder Morgan	6.0	6.5	-10%
Hilton Hotels	5.0	6.0	-20%				

Volatility Decreasers

	# Firms	% of Total
Consumer Discretionary	12	18%
Consumer Staples	3	5%
Energy	6	9%
Financials	8	12%
Health Care	10	15%
Industrials	8	12%
Information Technology	12	18%
Materials	1	2%
Telecom	0	0%
Utilities	5	8%
	65	100%

Just as shortening the life will decrease the estimated value of an option with the Black-Scholes option pricing model, so will a decrease in the volatility factor. The table at left shows the distribution by sector of the 64 firms that decreased their volatility inputs in 2002 versus 2001; the table on the next page shows the changes in the volatility inputs by company.

The distribution at left displays a curiosity: the technology sector is notorious for its stock market volatility, yet in 2002, many firms in the sector implicitly believe their stock prices will become less volatile over the expected life of options granted.

2002 Volatility Decreasers

	2002 Volatility	2001 Volatility	Change	% Chg.		2002 Volatility	2001 Volatility	Change	% Chg.
Block, H&R	28.8%	61.2%	-32.4%	-52.9%	Agilent Technologies	63.0%	77.0%	-14.0%	-18.2%
UST	17 2%	30 3%	-13 1%	-43 2%	Norfolk Southern	32 0%	39 0%	-7 0%	-17 9%
Watson Pharmaceuticals	38 0%	65.0%	-27.0%	-41.5%	ACE Limited	35.2%	42.8%	-7.6%	-17.8%
United Parcel Service	20 2%	32 4%	-12 2%	-37 5%	Huntington Bancsh	33 8%	41 0%	-7 2%	-17 6%
Forest Laboratories	27 6%	43 6%	-16.0%	-36.6%	Southtrust	28.0%	34.0%	-6 0%	-17.6%
McKesson HBOC	31 5%	48 5%	-17 0%	-35 1%	Loews	29 2%	35 2%	-6 0%	-17 0%
Compuware	64.6%	95.6%	-31.0%	-32.4%	McCormick & Co	21.6%	26.0%	-4.4%	-16.9%
Tupperware	27 5%	40 0%	-12 5%	-31 3%	Kerr-McGee	36 0%	42 9%	-6 9%	-16 1%
Apollo Group	42.0%	61.0%	-19.0%	-31.1%	Ebay	68.0%	81.0%	-13 0%	-16.0%
Ciena Corp	92 0%	131 0%	-39 0%	-29 8%	Fortune Brands	30 6%	36 4%	-5 8%	-15 9%
Dell	43.0%	61.2%	-18.2%	-29.7%	Genuine Parts	22.0%	26.0%	-4.0%	-15.4%
Hilton Hotels	34 0%	48 0%	-14 0%	-29 2%	Power-One	94 7%	111 9%	-17 2%	-15 4%
ADC Telecommunications	67.0%	93.2%	-26 2%	-28.1%	Liz Claiborne	39 0%	46 0%	-7.0%	-15.2%
Medtronic	27 2%	37 8%	-10 6%	-28 0%	Baker Hughes	45 0%	53 0%	-8 0%	-15 1%
Zimmer Holdings	30.3%	41.7%	-11.4%	-27.3%	Snap-On	33.1%	38.7%	-5 6%	-14 5%
Siebel Systems	65 0%	89 3%	-24 3%	-27 2%	FedEx	30 0%	35 0%	-5 0%	-14 3%
BJ Services	46.2%	63.0%	-16.8%	-26.7%	Adobe Systems	69 0%	80.0%	-11 0%	-13.8%
AON	21 0%	28 0%	-7 0%	-25 0%	Principal Financial Gp	32 5%	37 5%	-5 0%	-13 3%
Stanley Works	30.0%	40.0%	-10.0%	-25.0%	HCR Manor Care	40.0%	46.0%	-6.0%	-13.0%
Oracle	57 0%	76 0%	-19 0%	-25 0%	Avery Dennison	29 1%	33 4%	-4 3%	-12 9%
Harrah's Entertainment	32.0%	42.0%	-10.0%	-23.8%	United Health Group	40 2%	45 9%	-5.7%	-12.4%
Medimmune	53 0%	69 0%	-16 0%	-23 2%	Hasbro	43 0%	49 0%	-6 0%	-12 2%
Procter & Gamble	20 0%	26 0%	-6.0%	-23.1%	Molex	52 0%	58.9%	-6.9%	-11.7%
Constellation Energy Group	31 9%	41 3%	-9 4%	-22 8%	Chevron Texaco Corp	21 6%	24 4%	-2 8%	-11 5%
Keyspan	22 5%	29 0%	-6.6%	-22.6%	SLM Corporation	31.0%	35.0%	-4.0%	-11.4%
Broadcom	70 0%	90 0%	-20 0%	-22 2%	Burlington Resources	31 0%	35 0%	-4 0%	-11 4%
Applied Micro Circuits	105.0%	133.0%	-28.0%	-21.1%	Millipore	40.0%	45.0%	-5.0%	-11.1%
AES Corp	68 0%	86 0%	-18 0%	-20 9%	American Power Conv	74 0%	83 0%	-9 0%	-10 8%
Bausch & Lomb	38.4%	48.2%	-9.8%	-20.4%	AOL Time Warner	52.9%	59.3%	-6.4%	-10.8%
Ford	35 0%	43 9%	-8 9%	-20 3%	Allegheny Technol	35 0%	39 0%	-4 0%	-10 3%
KeyCorp	26.4%	33.0%	-6.6%	-20.0%	Apache	37 2%	41.4%	-4.2%	-10 2%
Pinnacle West Capital	22 6%	27 7%	-5 1%	-18 3%	Nicor	21 1%	23 5%	-2 4%	-10 2%

Assumption Double-Dippers

	# Firms	% of Total
Consumer Discretionary	3	13%
Consumer Staples	0	0%
Energy	1	4%
Financials	4	17%
Health Care	5	22%
Industrials	4	17%
Information Technology	4	17%
Materials	1	4%
Telecom	0	0%
Utilities	1	4%
	23	100%

Lastly, there were a few companies that decreased *both* assumptions - which contains an implicit contradiction. Decreasing volatility in a Black-Scholes world means a lower likelihood of exercising an option profitably: if the stock will fluctuate less, there won't be as many chances it will be above the strike price. On the other hand, decreasing the life of the options implies that an earlier exercise is expected. The two assumption changes simply don't mesh together. Below, the sector distribution of these kinds of assumption changers; the companies are presented in the table on the following page.

Firms Employing 2002 Assumptions Of Shorter Lives & Lower Volatility

	2002 Volatility	2001 Volatility	Volatility Change	2002 Exp. Life	2001 Exp. Life	Expected Life Change
ADC Telecommunications	67.0%	93.2%	-26.2%	4.3	4.4	-0.1
Apache	37 2%	41 4%	-4.2%	4 5	5	-0.5
Apollo Group	42.0%	61.0%	-19.0%	2 8	3.1	-0.3
Avery Dennison	29 1%	33 4%	-4.3%	7	10	-3.0
Boston Scientific	49.8%	51.4%	-1 6%	5	6	-1.0
Compuware	64 6%	95 6%	-31.0%	4 1	5	-0.9
Comverse Technology	75.0%	76.0%	-1 0%	2 6	4.3	-1.7
Danaher	33 8%	36 0%	-2 2%	8	10	-2.0
Electronic Arts	72.0%	74.0%	-2.0%	2 25	2.32	-0.1
Federated Investors, Inc	28 4%	29 9%	-1.5%	6 7	8 3	-1.6
FirstEnergy	23.3%	23.5%	-0.1%	8.1	8.3	-0.2
HCA	37 0%	38 0%	-1.0%	4	6	-2.0
Hercules	34 6%	35.5%	-0.9%	6	8	-2.0
Hilton Hotels	34 0%	48 0%	-14.0%	5	6	-1.0
Home Depot	44.3%	48.1%	-3.8%	5	6	-1 0
Power-One	94 7%	111 9%	-17.2%	5 8	6 5	-0.7
SLM Corporation	31 0%	35.0%	-4.0%	3	10	-7.0
Stanley Works	30 0%	40 0%	-10 0%	5	7	-2 0
Stryker	37.4%	38.0%	-0.6%	6.5	6.6	-0 1
Torchmark	30 1%	31 7%	-1.6%	4 51	4 75	-0.2
Union Planters	29.6%	29.8%	-0.1%	3.9	5.1	-1.2
United Health Group	40 2%	45 9%	-5.7%	4 5	4 8	-0.3
Zimmer Holdings	30.3%	41.7%	-11.4%	5	7	-2.0

"Sea Hunt" Sectors: Underwater Options

	# Firms	% of Total
Information Technology	55	21%
Consumer Discretionary	43	16%
Financials	32	12%
Industrials	31	12%
Materials	22	8%
Utilities	21	8%
Health Care	20	8%
Consumer Staples	19	7%
Telecom	10	4%
Energy	10	4%
	263	100%

There's one last point of view of option valuation that's worth mentioning, one that has to do with the current value of the options rather than esoteric arguments over what they're worth at the grant date. Call it the "Jacques Cousteau" point of view, for what we're considering is the options that are below strike price or more colloquially, the underwater options. There are 263 of these options out there, based on the closing price at the end of April, 2003 and the average exercise price of options outstanding as disclosed in the most recent annual report footnotes. The table at left shows that the greatest proportion of them are in the technology sector. Maybe Mr. Cousteau would be happy, but nobody else is.

The table on the next page shows the 90 companies whose options were underwater by a margin of 40% or more.

Underwater Options

	Price, 4/30/03	Exercise Price	% Difference		Price, 4/30/03	Exercise Price	% Difference
Lucent	$1.80	16.73	-89%	PerkinElmer	$9.92	23.32	-58%
JDS Uniphase	3.23	26.11	-88%	AOL Time Warner	13.68	31.91	-57%
El Paso	7.50	49.18	-85%	Centerpoint Energy	7.90	18.26	-57%
Gateway	2.88	18.68	-85%	Scientific-Atlanta	16.25	36.13	-55%
Solectron	3.19	18.50	-83%	Goodrich	14.07	30.93	-55%
Mirant	3.31	17.68	-81%	Sprint - FON	11.51	24.78	-54%
Goodyear	5.72	30.28	-81%	Applera: Applied Biosys	17.53	37.40	-53%
Sprint - PCS	3.50	18.44	-81%	Visteon	7.01	14.78	-53%
Allegheny Technologies	4.15	20.42	-80%	Microsoft	25.56	53.75	-52%
Corning	5.42	26.47	-80%	Ford	10.30	20.88	-51%
Sun Microsystems	3.31	15.86	-79%	Teradyne	11.60	23.41	-50%
McDermott	3.25	15.38	-79%	Siebel Systems	8.66	17.42	-50%
Dynegy	4.40	20.74	-79%	Toys R Us	10.25	20.43	-50%
CMS Energy	6.23	27.18	-77%	Apple Computer	14.22	28.17	-50%
Circuit City Stores	5.73	23.60	-76%	Hewlett-Packard	16.30	32.00	-49%
ADC Telecommunications	2.38	9.54	-75%	Schering-Plough	18.10	35.40	-49%
Avaya	3.90	15.46	-75%	Xcel Energy	13.52	26.29	-49%
Ciena	4.88	19.20	-75%	Duke Energy	17.59	34.00	-48%
Tellabs	6.15	22.49	-73%	Safeway	16.62	31.70	-48%
AT&T Wireless Services	6.46	23.09	-72%	Unisys	10.40	19.73	-47%
Providian Financial	7.37	26.18	-72%	Georgia-Pacific	15.44	28.41	-46%
Delta Air Lines	12.79	44.00	-71%	Cisco	15.00	27.17	-45%
LSI Logic	5.36	18.24	-71%	Delphi	8.40	15.18	-45%
Parametric Technology	3.30	11.12	-70%	United States Steel	14.32	25.84	-45%
Dana	9.29	30.14	-69%	Power-One	5.86	10.51	-44%
Micron Technology	8.50	26.96	-69%	Charles Schwab	8.63	15.38	-44%
Hercules	10.15	30.48	-67%	Phelps Dodge	31.19	55.36	-44%
Electronic Data Systems	18.15	53.00	-66%	Computer Associates	16.24	28.83	-44%
Sanmina-SCI	4.80	13.99	-66%	Sabre Hldgs.	20.91	37.06	-44%
Andrew Corp	7.67	22.20	-66%	Dillard's	13.98	24.72	-43%
Williams Cos.	6.95	19.85	-65%	Thomas & Betts	15.81	27.83	-43%
Novell	2.75	7.75	-65%	NCR	21.92	38.21	-43%
Compuware	4.37	12.30	-65%	BMC Software	14.92	26.00	-43%
Applied Micro Circuits	4.47	12.33	-64%	Calpine	5.37	9.30	-42%
AES	6.01	16.37	-63%	TMP Worldwide	16.76	28.91	-42%
UnumProvident	11.50	31.11	-63%	Broadcom	17.89	30.84	-42%
Xerox	9.86	26.00	-62%	Tenet Healthcare	14.84	25.45	-42%
Interpublic Group	11.40	29.00	-61%	Veritas Software	22.07	37.85	-42%
Motorola	7.91	20.00	-61%	Convergys	16.22	27.70	-41%
Agilent Technologies	16.02	40.00	-60%	Winn-Dixie Stores	12.53	21.38	-41%
Advanced Micro Devices	7.44	18.58	-60%	CIGNA	52.30	88.71	-41%
EMC	9.09	22.56	-60%	Textron	29.49	49.62	-41%
Tyco	15.60	37.80	-59%	Honeywell	23.60	39.50	-40%
TECO Energy	10.79	25.92	-58%	Baxter	23.00	38.44	-40%
AT&T	17.05	40.64	-58%	Louisiana-Pacific	8.08	13.51	-40%

Option valuation will always be a slippery subject, no matter what direction the FASB or IASB head. That doesn't mean zero is a better answer; as pointed out earlier, companies and investors have to be willing to apply their acceptance of pervasive estimates in financial statements to the area of options just as they accept it in the area of say, loan loss reserves or depreciable lives.

IV. More Hidden Effects: Tax Benefits

So far, we're well aware that the present option compensation accounting leaves much information hidden in the footnotes. Some of it will never leap out at you even if mandatory expensing occurs, like the information about grants - yet it's useful if you're trying to understand what makes option compensation expense what it is.

The same is true for the tax effects. The Federal tax code permits firms with "non-qualified" plans to take a tax deduction for the difference between the exercise price of stock options and fair value at the date of the exercise. To encourage more widespread employee ownership, the tax code provides rewards. Those rewards are not visible in the income tax provision in the income statement. Because they relate to transactions involving stockholders - remember, an employee exercising an option becomes a stockholder - the tax benefits are recorded as a component of stockholders' equity. They also show up in the cash flow statement in the "operating" section. Sometimes those tax benefits exceed a firm's operating cash flows - but you have to root around to find out.

The tax code fosters the promotion of compensation plans that are heavily weighted towards options. Firms are denied tax deductible status for CEO compensation and compensation of the four other highest ranking officers in excess of $1,000,000, unless it includes "performance-based compensation." (Read: options.) To achieve deductibility, one or more performance goals must be reached, but only if:

• the performance goals are determined by a compensation committee of the board of directors of the firm which is comprised of two or more outside directors,

• the material terms under which the remuneration is to be paid, including performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before payment, and

• before any payment of such remuneration, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.[2]

The road to hell is paved with good intentions. While trying to narrow the pay gap between executives and workers, this 1993 amendment of the tax code kindled the rise of the options culture in the mid-to-late 1990's. The director provisions made it even more important for a CEO to stack the compensation committee of board with chums or at least, tractable fellows, instead of skeptical watchdog types.

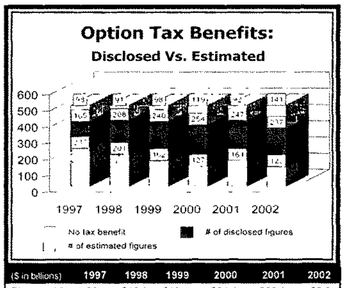
<u>The tax benefits have amounted to a government subsidy determined by how well the stock price of the firm performs: a strange criteria for providing tax rewards</u>. Call it another perverse incentive for managements to do "whatever it takes" to get the stock price higher - including accounting chicanery. Below, the tax benefits attributable to stock options in the last five years for the S&P 500 in the aggregate, sorted by change in 2002.

Tax Benefits From Option Exercises

	2002		2001		2000		1999		1998		1997
Telecom	$0.1	-70%	$0.3	-60%	$0.8	-10%	$0.9	99%	$0.4	163%	$0.2
Information Technology	3.4	-65%	9.9	-48%	18.9	92%	9.8	100%	4.9	58%	3.1
Energy	0.1	-52%	0.3	-39%	0.4	99%	0.2	-6%	0.2	-13%	0.3
Utilities	0.1	-50%	0.2	-8%	0.2	129%	0.1	-26%	0.1	82%	0.1
Consumer Discretionary	1.6	-47%	3.1	22%	2.5	7%	2.4	61%	1.5	77%	0.8
Financials	2.2	-45%	4.0	-14%	4.6	34%	3.5	27%	2.7	21%	2.3
Health Care	1.7	-31%	2.4	-35%	3.8	53%	2.5	7%	2.3	128%	1.0
Industrials	1.0	-20%	1.3	-19%	1.6	4%	1.5	19%	1.3	31%	1.0
Materials	0.2	-19%	0.2	16%	0.2	-41%	0.3	133%	0.1	-34%	0.2
Consumer Staples	0.8	-10%	0.9	-7%	1.0	-1%	1.0	10%	0.9	-9%	1.0
Aggregate	**$13.5**	**-41%**	**$22.8**	**-33%**	**$34.1**	**51%**	**$22.5**	**55%**	**$14.5**	**47%**	**$9.9**

[2] Adapted from the Section 162(m) of the Internal Revenue Code.

As you might have expected, the tax benefits tied to option exercise were down for 2002 - completely to be expected. If stock prices are in a funk, you can't expect as many profitable exercises - or that any of them would be as profitable - as when the stock market was smoking in the late 1990's. The size of the decrease is startling on the other hand: a 50% drop after a decrease of 34% in 2001. That makes for bigger cash outflows for profitable firms sans a foamy stock price: their stock market tax shield is gone.



($ in billions)	1997	1998	1999	2000	2001	2002
Disclosed $	$6.1	$10.9	$18.1	$31.1	$20.1	$9.8
Estimated $	3.8	3.7	4.1	2.9	2.5	1.5
	$9.9	$14.5	$22.1	$34.0	$22.6	$11.3

One note about the figures in the previous table: some of the figures contain estimated amounts of tax benefit for individual firms. Though accounting standards[3] require the disclosure of the tax benefit, some firms nevertheless do not report the amount. The chart at left summarizes the headcount of the reporters, the non-reporters and those without any discernible tax benefits. The table below it summarizes the amounts disclosed and estimated.

The estimate of the tax benefit was a straightforward affair: the low price for the year was assumed to be the exercise price, only for the sake of minimizing the estimates. The difference between the two prices was multiplied by the number of options exercised, then multiplied by the 35% federal tax rate. The result was the estimated tax benefit. Below, an example using Altria Group's information.

Estimating Altria Group's Tax Benefits

2002 Low stock price	$35.40
Weighted average exercise price	30.33
Tax deduction	5.07
Options exercised (millions)	x 24.116
Total deduction	122.3
Statutory tax rate	35%
Estimated tax benefit	$42.8

The tax benefits in 2002 were small relative to past government largesse - and as usual, a handful of the biggest firms received the most tax benefit. Put it this way: a mere 50 firms received an estimated $7.6 billion of tax benefits in 2002 - about 70% of the total. (See table below.) Maybe the tax code writers were hoping to spur innovation by giving smaller firms a tax break but it's the big ones who enjoy the most benefit.

Tax Benefit Concentrations

2002		2002		2001		2000		1999		1998		1997	
12	Information Technology	$2 9	21%	$6 3	28%	$12 5	37%	$6 8	31%	$3 5	24%	$2 1	21%
8	Financials	1.6	12%	2.9	13%	3.3	10%	2.0	9%	1.7	12%	1 2	12%
8	Health Care	1 2	25%	1 4	6%	2 6	8%	1 3	6%	1 0	7%	0 5	5%
8	Consumer Discretionary	0.8	6%	2.1	9%	1.4	4%	1 1	5%	0 3	2%	0.1	1%
7	Consumer Staples	0 6	4%	0 5	2%	0 5	2%	0 6	3%	0 4	3%	0 3	3%
6	Industrials	0.5	4%	0.5	2%	0.7	2%	0 6	2%	0.5	3%	0.3	3%
1	Energy	0 1	1%	0 1	0%	0 2	1%	0 1	1%	0 2	1%	0 1	1%
0	Materials	0.0	0%	0 0	0%	0.0	0%	0.0	0%	0.0	0%	0.0	0%
0	Telecom	0 0	0%	0 0	0%	0 0	0%	0 0	0%	0 0	0%	0 0	0%
0	Utilities	0 0	0%	0 0	0%	0.0	0%	0 0	0%	0.0	0%	0.0	0%
50	**Top 50 companies**	**$7.6**	**68%**	**$13.9**	**62%**	**$21.2**	**62%**	**$12.5**	**56%**	**$7.7**	**53%**	**$4.7**	**48%**
309	Remaining firms	3.7	32%	8 7	38%	12 8	38%	9 7	44%	6 8	47%	5 2	52%
359	**Aggregate**	**$11.3**	**100%**	**$22.6**	**100%**	**$34.0**	**100%**	**$22.5**	**100%**	**$14.5**	**100%**	**$9.9**	**100%**

[3]Emerging Issues Task Force Consensus No. 00-15, " Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Stock Option."

Below, a table showing the top fifty firms and their tax benefits. (Note: the table is keyed in terms of the top 50 for 2002 only.) The previous years are presented to provide a comparison.

Top 50 Beneficiaries Of Stock Option Tax Deductions

($ in millions. "E" indicates estimated amount)		2002	2001	2000	1999	1998	1997
Microsoft	Information Technology	1,596	2,066	5,535	3,107	1,553	792
Citigroup	Financials	381	674	1,400	1,017	708	728
Lehman Bros.	Financials	347	549	373	90	59	0
Morgan Stanley	Financials	282	460	467	367	370	111
Intel	Information Technology	270	435	887	506	415	224
Dell	Information Technology	260	487	929	1,040	444	164
Amgen	Health Care	252	245	377	152	108	55
Pfizer	Health Care	238	395	1,306	470	439	132
Viacom	Consumer Discretionary	210	142	219	59	55	0
Merrill Lynch & Co	Financials	196	790	800	281	336	173
Tenet Healthcare	Health Care	176	74	3	3	0	0
AOL Time Warner	Consumer Discretionary	161	1,446	711	551	(2)	25
Johnson & Johnson	Health Care	160 E	228 E	169 E	201 E	52 E	29
MBNA	Financials	150	69	59	35	49	23
Pepsico	Consumer Staples	143	212	177	105	109	111
Maxim Integrated	Information Technology	140	239	136	114	74	52
IBM	Information Technology	136	502	422	545	365	429
United Health Group	Health Care	133	133	116	23	47	37
Procter & Gamble	Consumer Staples	128 E	62 E	71 E	186 E	138 E	105
Bear Stearns	Financials	128	143	73	91	86	0
General Electric	Industrials	122 E	206 E	514 E	508 E	404 E	224
Sun Microsystems	Information Technology	98	816	708	222	112	64
Ebay	Consumer Discretionary	93	82	37	11	0	0
Exxon Mobil	Energy	87 E	109 E	187 E	134 E	175 E	130
United Parcel Service	Industrials	86 E	0	0	0	0	0
Best Buy	Consumer Discretionary	86	93	79	40	11	0
Wal Mart Stores	Consumer Discretionary	84	106	118	125	49	3
SLM Corporation	Financials	83	119	25	8	4	23
Merck & Co.	Health Care	83	153	538	423	351	237
HCA	Health Care	82	60	40	3	0	14
Anheuser-Busch	Consumer Staples	77	27	74	49	34	22
3M	Industrials	77	57	55	23 E	19 E	63
Applied Materials	Information Technology	75	107	387	161	28	83
Lockheed Martin	Industrials	75 E	21 E	0 E	0	15 E	22
Cardinal Health	Health Care	74	159	47	65	35	21
Wells Fargo & Co	Financials	73	88	112	88	102	93
Home Depot	Consumer Discretionary	68	138	137	132	63	26
McDonald's	Consumer Discretionary	61	70	80	185	154	79
Cisco Systems	Information Technology	61	1,397	3,077	837	422	274
Yahoo!	Information Technology	60	1	106	118	23	ND
KLA-Tencor	Information Technology	60	56	132	14	21	10
Block, H&R	Industrials	58	2	4	4 E	1 E	0
Walgreen	Consumer Staples	57	67	39	27	25	10
Tyco	Industrials	54	231	126	15	55	10
Intuit	Information Technology	53	60	94	58	22	7
General Mills	Consumer Staples	53	38	39	34	39	26
Xilinx	Information Technology	52	159	112	35	16	17
Colgate-Palmolive Co	Consumer Staples	51	54	92	169	(19)	28
Kroger	Consumer Staples	50	52	39	28	101	40
Yum! Brands	Consumer Discretionary	49	13	5	4	2	1

Try to spot the struggling upstart in the top 50 tax benefit beneficiaries in the list above. All of these firms would be considered by most folks to quite well established.

One of the traditional rationales for stock option issuance is that they help small cash-poor innovative firms to "attract and retain" the best minds for their businesses and save on cash, both through the substitution for compensation and from the tax benefits as well. It's a perfectly logical rationale and no doubt there's some truth to it. The problem arises when their bigger competitors get the same benefits: not only do they get to "attract and retain" able personnel, they get to "deduct and drain" from the Treasury Department in a big way - adding one more tool to their arsenal that might help them overpower less established competitors.

Some companies depend a great deal on the benefits of stock option tax benefits: during the tech boom, there was no shortage of stories about companies whose cash generated from operations was minor compared to their tax benefits. Even after the tech boom ended, companies like that still exist: in 2002, there were 15 companies whose stock option-related tax benefits exceeded their cash from operating activities. You might expect it to happen occasionally - say in the case of an unusual merger where holders exercised their options all at one time - but some of these firms have had option tax benefits greater than cash from operations for as many as four years in a row. Look at the table below and you can see this was the case for **Morgan Stanley** and **Lucent**.

Cash From Option Tax Benefits: Better Than Operating The Business In 2002

	Cash From Operations				Option Tax Benefits				Benefits > Cash From Ops.			
($ in millions)	2002	2001	2000	1999	2002	2001	2000	1999	2002	2001	2000	1999
Morgan Stanley	(5,054)	(24,091)	(2,384)	(29,271)	282	460	467	367	5,336	24,551	2,851	29,638
Bear Stearns	(1,368)	6,552	(4,239)	235	128	143	73	91	1,496	(6,409)	4,312	(144)
Williams Companies	(542)	1,694	506	1,488	32	48	37	32	575	(1,645)	(469)	(1,456)
Sears	(505)	2,262	2,702	3,697	24	14	3	8	529	(2,248)	(2,699)	(3,689)
Countrywide	(3,672)	(8,950)	(3,310)	2,445	22	9	17	2	3,694	8,958	3,328	(2,443)
Applied Micro Circuit	(36)	200	65	22	18	169	15	4	54	(31)	(50)	(18)
Navistar Int'l	(74)	220	686	302	7	0	0	2	81	(220)	(686)	(300)
Broadcom	(69)	49	201	66	7	23	466	154	76	(26)	265	88
Goldman Sachs	(10,077)	(15,176)	11,135	(12,589)	2	0	0	0	10,079	15,176	(11,135)	12,589
TMP Worldwide	(15)	191	187	94	2	22	17	12	16	(169)	(170)	(82)
Lucent	(756)	(3,657)	40	(276)	1	18	1,064	394	757	3,675	1,024	670
Gateway	(25)	(270)	289	731	1	1	56	80	25	271	(233)	(651)
Parametric Tech	(23)	51	52	151	0	2	18	3	23	(49)	(34)	(148)

Cash from operations data drawn from Compustat Research Insight database. All other information drawn directly from 10-K's or estimated as described above.

Executives like to gripe that required options expensing will kill a wonderful employee incentive, but if there was one rule change that would effectively kill option issuance, it would be the elimination of their tax benefits. By now, you've probably picked up the fact that there has been a marked decrease in options issuance even without the stimulus of required expense treatment or a change in tax laws. Maybe a cool stock market does the trick just as well.

V. Options: The Out-Of-Alignment Incentive

If you say something long enough and loud enough, people begin to accept it as gospel truth - even if it's patently untruthful.

So it is with options supporters and their "alignment with shareholders" argument. Maybe there's alignment with shareholders in that both the option holders and stockholders benefit when the price of the stock goes up - but in wildly varying degrees. (See the example in the box.) There certainly is a difference in "alignment" when the stock goes down: the option holder, not being out of pocket for cash doesn't feel pain quite the same way as a cash equity investor.

Fortunately, it's not too hard to check up on such an unquestioned article of faith. Figure it this way: if management's interests are heavily aligned with shareholders by option grants, then the companies with the most option grants in their capital structure should be the ones most firmly focused on profitable projects for shareholders. Abundant options should insure that the management will want to partake in the benefits they provide to shareholders, which will be recognized in the stock market - or so the theory goes. If more alignment is a good thing for management to have, then managers of "high-option" firms should be engaging in projects that will better reward shareholders, and so be recognized in the stock market with a better-than-average stock price. Conversely, managements of firms with low option presence don't have as much interest in engaging in actions that will be recognized by the stock market, and so low-option firms would be expected to perform worse than their high-option counterparts.

We can see if this theory holds up by parsing the S&P 500 into two camps: those companies with above average option levels in their capital structure and below average levels of capital structure. Then their stocks' five year total returns can be compared to that of the S&P 500 as a whole.

There were 450 companies in the S&P 500 that were publicly traded for a full five years, and we can define "degree of option presence" by dividing the average options outstanding[4] by the basic shares outstanding for a firm. The popular term for this measure is "overhang;" not as descriptive, but easier to say. The table below shows the degree of option presence in capital structure by sector for the 450 companies.

Options Presence: Average Options Outstanding To Basic Shares

	# Firms	2002	2001	2000	1999	1998
Information Technology	70	15.3%	14.3%	13.4%	13.1%	12.6%
Health Care	43	10.3%	9.9%	9.2%	8.2%	8.0%
Consumer Discretionary	84	9.9%	9.5%	8.6%	7.4%	6.8%
Industrials	63	9.1%	8.7%	8.1%	7.1%	6.2%
Financials	69	8.7%	7.9%	7.1%	6.3%	5.7%
Materials	31	7.8%	7.4%	6.6%	5.5%	4.6%
Telecom	8	7.7%	6.4%	5.1%	4.5%	4.3%
Consumer Staples	32	7.6%	7.0%	6.3%	5.5%	5.2%
Energy	23	5.5%	5.0%	4.9%	5.1%	4.5%
Utilities	27	4.5%	4.1%	3.6%	2.9%	2.5%
Average Options "Overhang"	450	9.3%	8.6%	7.8%	7.3%	7.1%

[4]Simple average of all beginning of year options outstanding and end of year options outstanding; no other data available to smooth average further. Also, all options used whether or not exercisable or "in the money." The objective is to determine the maximum amount of potential dilution in the capital structure, rather than the existing dilution at a certain point in time.

"Alignment" Is A Matter Of Degree

	Year 1	...	Year 5	CAGR
Shareholder - cash out in beginning of Year 1	$20		$50	20.1%
Employee - option award in Year 1	$20		$20	150.0%

In Year 1, a shareholder pays cash for stock while an employee receives an option with no cash outlay. The shareholder hangs on for five years and realizes a $50 sale of the stock at the end of Year 5. The employee exercises his option on the same day in Year 5. Both put out the same amount of cash, though the timing was far different - resulting in wildly different rates of return on cash invested. Option holders will always have a huge advantage over shareholders in terms of return rates, a mathematical fact due to the timing of cash flows. If the stock goes to zero, the cash investor has a 100% loss. It's not much of an "alignment of interests."

Not surprisingly, the technology sector is far and away the one with the greatest degree of options overhang, and the one that would dilute its shareholders the most should they all be exercised. (Note that the calculation is based on all options outstanding, whether they're in the money or not; it's a measure of potential dilution.) Consistent with the run-up in options grants in years 1998 through 2001, the option overhang increased in every sector in every year shown in the table. Remember that these figures are *averages:* there are some companies out there with *really* pumped-up option overhangs. In fact, 119 of them are above the average for each of the last five years. The companies are listed in the table on the next page, and the sector distribution of them is shown below. No surprises again: the technology sector leads the pack, while the telecom and utility sectors are no-shows.

High "Options Overhang" By Sector

	# Firms	2002	2001	2000	1999	1998
Consumer Discretionary	**25**	14.0%	12.8%	13.7%	13.5%	13.8%
Consumer Staples	**2**	12 0%	11 5%	11 5%	10 5%	10 9%
Energy	**1**	14.9%	13.3%	14.5%	18.3%	16.4%
Financials	**12**	17 5%	15.1%	13 6%	12 4%	11 3%
Health Care	**15**	13.8%	13.3%	12.4%	11.1%	10.9%
Industrials	**13**	16 3%	15 5%	15 5%	14 6%	13 3%
Information Technology	**48**	15.7%	15.0%	13.8%	13.8%	14.0%
Materials	**3**	11 8%	12 5%	12 3%	10 7%	8 8%
Average for "heavy" option overhang group	**119**	**15.5%**	**14.5%**	**13.7%**	**13.4%**	**13.4%**

According to the "alignment" proposition, the managements of these 119 firms are more aligned with their stockholders than the other 331, so the question must be asked: did the market recognize that these managements were motivated to do more for shareholders? Did the stocks of these firms perform better over a five year period than those firms whose managers were less "aligned with shareholders?"

High-Overhang Market Beaters			High-Overhang Market Losers		
#	Sector	%	#	Sector	%
29	Information Technology	40%	19	Information Technology	42%
14	Consumer Discretionary	21%	11	Consumer Discretionary	24%
13	Health Care	13%	9	Industrials	20%
10	Financials	11%	2	Financials	4%
4	Industrials	10%	2	Health Care	4%
2	Consumer Staples	3%	1	Energy	2%
2	Materials	2%	1	Materials	2%
0	Energy	1%	0	Consumer Staples	0%
0	Telecom	0%	0	Telecom	0%
0	Utilities	0%	0	Utilities	0%
74		**100%**	**45**		**100%**

The answer is in the table at left: 74 of the 119 high-overhang companies outperformed the market, or 62% of them. Sounds impressive, but true believers in the alignment story should be disappointed. There shouldn't have been 45 companies that were beaten by the market - all of them should be market-beaters. One curiosity: the technology sector often cites the alignment story as an excuse for grants gone wild - but they represent nearly identical proportions of the market-beaters and beaten.

High "Options Overhang" By Company

	2002	2001	2000	1999	1998
Siebel Systems	45.5%	46.3%	41.3%	41.8%	35.6%
Delta Air Lines	44 7%	41 4%	39 7%	34 6%	22 6%
Lehman Bros.	31.0%	25 3%	20.3%	14.3%	8.9%
Apple Computer	29 1%	24 3%	16 6%	13 0%	14 1%
Maxim Integrated	28.2%	26.5%	27.4%	29.6%	34.6%
Parametric Tech	27 0%	24 0%	21 2%	19 4%	16 2%
Quintiles Transnat'l	26.9%	24.1%	19 4%	12.4%	9.3%
Autodesk	25 9%	25 8%	25 7%	24 7%	24 9%
Mercury Interactive	25 2%	22.4%	18 7%	16 3%	18 2%
Merrill Lynch & Co	24 1%	22 7%	23 5%	22 3%	19 7%
Adobe Systems	23.7%	20.8%	17.5%	16.5%	14.0%
Capital One	23 2%	20 7%	18 8%	16 8%	12 8%
Network Appliance	22.9%	22.8%	24.0%	23.3%	19.7%
Citrix Systems	22 8%	22 3%	23 2%	21 2%	16 2%
Yahoo!	22.7%	22.4%	22.1%	24.6%	26.6%
Hasbro	22 6%	22 9%	21 0%	18 0%	17 1%
T. Rowe Price	22.5%	21.5%	20 3%	19.2%	19 2%
National Semi	22 5%	20 3%	19 7%	17 2%	11 9%
Cendant	22.3%	23.3%	25.6%	24.0%	20 6%
PeopleSoft	21 9%	20 7%	21 2%	19 6%	19 0%
McKesson HBOC	21.7%	20.7%	17.0%	11.6%	9.2%
Symantec	21 1%	20 0%	17 8%	17 5%	16 4%
Novell	20.7%	21.3%	18.7%	15.5%	12.8%
Analog Devices	20 5%	16 1%	13 8%	14 4%	13 2%
General Mills	20.3%	21.4%	18.6%	16.8%	15.8%
J P Morgan Chase	19 4%	15 3%	12 7%	12 6%	12 1%
Starwood	19.3%	15 2%	12.2%	10.3%	8 2%
New York Times	18 3%	16 4%	13 9%	12 0%	10 6%
Tupperware	18 2%	17.1%	13.5%	9.7%	7.2%
LSI Logic	17 7%	18 5%	16 7%	15 2%	11 9%
Yum!Brands	17.6%	18.3%	17.3%	15 3%	12 4%
AutoNation	17 5%	17 2%	15 0%	12 3%	11 3%
Teradyne	17.3%	14 9%	12.1%	12.0%	11.5%
Applied Materials	17 3%	16 8%	14 3%	14 0%	11 8%
Hercules	17.1%	16 8%	14 5%	12.2%	10.0%
First Tennessee	17 1%	16 6%	14 7%	11 5%	9 9%
Guidant	16.9%	14.5%	11.3%	10.3%	8.5%
Novellus Systems	16 8%	14 2%	13 0%	13 5%	14 5%
TMP Worldwide	16.7%	16.1%	15.7%	13.2%	8.2%
Intuit	16 6%	16 1%	15 7%	15 5%	17 3%
Advanced Micro Dev,	16.6%	14.6%	13.9%	14.0%	13.2%
Xilinx	16 6%	16 7%	18 7%	20 7%	19 1%
St. Jude Medical	16 5%	16.0%	14 6%	12 6%	11.3%
BMC Software	16 3%	13 5%	11 8%	12 1%	12 9%
NCR	16.3%	16.3%	16.0%	14.1%	12.6%
Sun Microsystems	16 3%	14 8%	13 9%	13 9%	14 1%
Electronic Arts	16.2%	16.9%	18.2%	17.5%	15.4%
Robert Half	16 2%	15 1%	14 5%	12 8%	10 4%
Veritas Software	16.1%	14.3%	13.7%	14.4%	16.9%
Eastman Kodak	15 9%	16 4%	13 4%	11 2%	9 1%
Microsoft	15.7%	16.2%	15 4%	16.5%	19 0%
Comverse Tech	15 5%	16 5%	15 5%	15 4%	17 3%
Cisco Systems	15 5%	14.1%	13.4%	13 3%	13.4%
Reebok	15 4%	15 0%	14 7%	15 7%	17 2%
McDonald's	15.4%	14.3%	12.9%	12.1%	11.7%
KB Home	15 3%	16 0%	13 6%	8 4%	7 2%
Darden Restaurants	15.2%	14.6%	12.9%	11.6%	10.9%
Toys R Us	15 2%	14 0%	15 3%	15 6%	11 5%
Altera	15.1%	13.8%	12.3%	12.3%	13.5%
Southwest Airlines	15 1%	12 8%	13 4%	13 5%	14 0%

	2002	2001	2000	1999	1998
Compuware	15.1%	12.5%	13.1%	13.8%	14.6%
KLA-Tencor	15 0%	13 1%	12 8%	13 6%	12 8%
Nabors Industries	14.9%	13.3%	14.5%	18.3%	16 4%
Donnelley, R R	14 8%	14 9%	12 9%	10 0%	9 4%
Qualcomm	14.6%	14.4%	16.4%	25.7%	29.7%
Morgan Stanley	14 5%	13 3%	12 3%	11 8%	11 1%
AOL Time Warner	14.4%	11.4%	16.5%	19.0%	24.6%
Dell	14 3%	13 3%	12 9%	13 5%	15 8%
Ryder	14.2%	14.7%	13 0%	8 8%	7.7%
Lucent	14 1%	16 4%	11 1%	8 9%	7 6%
Marsh & Mclennan	14.1%	12.0%	11.2%	10.7%	9.9%
Eaton	13 8%	14 5%	13 2%	11 2%	10 0%
United Health Group	13.4%	12.3%	12.8%	11 6%	9 3%
Sungard Data Systems	13 3%	11 7%	9 9%	8 7%	8 3%
Waters Corp	13.2%	12.7%	14.0%	16.6%	18.0%
Countrywide Financial	13 1%	12 3%	12 0%	11 3%	10 2%
Meredith	12.9%	12.5%	11.6%	10.6%	9.5%
Genzyme Corporation	12 9%	12 2%	13 8%	14 0%	15 8%
Bank Of America	12.8%	11.4%	10.2%	8.2%	7.6%
ADC Telecomm	12 8%	12 2%	13 0%	12 1%	9 8%
Linear Technology	12.7%	12.9%	13.5%	14.3%	13.5%
Chiron	12 7%	10 8%	9 8%	10 3%	12 4%
PMC-Sierra, Inc	12.7%	16.7%	15.1%	14 7%	12 0%
Jones Apparel Group	12 5%	13 6%	11 9%	10 3%	10 2%
PerkinElmer	12.5%	12.4%	9.6%	8.6%	8.3%
Biogen	12 4%	11 7%	11 7%	13 4%	15 1%
Knight-Ridder	12.3%	13.2%	11.5%	8.7%	8.2%
Bausch & Lomb	12 2%	10 3%	8 6%	8 2%	9 2%
Ciena Corp	12 2%	12.5%	10.8%	9.2%	7.9%
Charter One Financial	12 2%	10 6%	9 1%	8 2%	7 5%
Intel	12.1%	10.5%	9.3%	9.3%	9.9%
JDS Uniphase	12 1%	14 3%	16 2%	22 3%	17 0%
Micron Technology	11.8%	9.3%	8.9%	9.0%	10.2%
IMS Health	11 7%	13 2%	13 6%	10 2%	11 2%
CSX	11.6%	10.3%	9.1%	8.2%	7.7%
Centex	11 6%	12 1%	11 9%	10 1%	9 0%
Becton, Dickinson	11.4%	11.4%	12.0%	12.0%	12 2%
McDermott Int'l	11 4%	9 4%	8 1%	7 4%	8 3%
Staples	11.3%	10.8%	9.7%	8.8%	9.7%
Scientific-Atlanta	11 1%	9 5%	8 4%	7 9%	8 2%
Millipore	10.9%	12.3%	11.5%	10.0%	8.6%
Starbucks	10 8%	11 2%	11 7%	11 6%	10 6%
Office Depot	10.8%	12.0%	11.3%	9 0%	8.2%
Gap	10 8%	12 0%	11 2%	11 1%	10 2%
Mattel	10.7%	12.7%	13.7%	13 5%	13.3%
Interpublic	10 7%	9 9%	9 7%	10 2%	10 7%
Boston Scientific	10.6%	11.0%	9.4%	7.9%	8.3%
Pepsico	10 5%	9 9%	10 3%	9 5%	9 9%
Pulte Homes Inc	10.5%	12.1%	13.2%	11.5%	11.0%
Wendy's Int'l	10 5%	10 9%	10 3%	9 0%	7 9%
Lexmark	10.3%	10 2%	10.3%	10.4%	10.2%
Apartment Inv & Mgmt	10 3%	11 4%	12 5%	13 6%	11 1%
Medimmune	9.9%	9.9%	10.3%	12.3%	14.1%
Concord EFS	9 7%	9 3%	9 0%	8 0%	7 4%
United Technologies	9.7%	9.1%	9 3%	9.2%	8.9%
ITT Industries	9 5%	12 1%	13 4%	13 4%	10 4%
Engelhard	9 5%	11.8%	13.5%	11.5%	9.0%
Forest Laboratories	9 4%	10 4%	11 5%	12 7%	13 9%
Ecolab	9 4%	9.5%	9.1%	8.7%	7 7%

A corollary to the alignment story: companies with low option overhangs (below average option presence in their capital structures) are not as aligned or concerned about their shareholders; their managements might be more interested in empire-building or featherbedding instead of making the stock price dance. So, returns for option-light firms should be subpar. There are 151 firms in the S&P 500 with below average option overhangs in each of the last five years; let's look at their last five years' returns.

Low-Overhang Market Beaters			Low-Overhang Market Losers		
#	Sector	%	#	Sector	%
22	Financials	21%	19	Information Technology	42%
19	Consumer Discretionary	18%	11	Consumer Discretionary	24%
13	Utilities	12%	9	Industrials	20%
12	Industrials	11%	2	Financials	4%
10	Consumer Staples	9%	2	Health Care	4%
10	Energy	9%	1	Energy	2%
9	Materials	8%	1	Materials	2%
6	Health Care	6%	0	Consumer Staples	0%
3	Telecom	3%	0	Telecom	0%
2	Information Technology	2%	0	Utilities	0%
106		**100%**	**45**		**100%**

Surprise: a greater proportion of companies with lower than average option overhang outperformed the market over the five year stretch - 106 out of 151, or 70% of them. Another curiosity: out of the low-overhang losers, most of them were in the technology sector. Maybe that means that for technology firms, excessive option grants are needed to outperform the market.

In sum, if one looks at the returns of the firm that would tend to support the alignment theory, the evidence is pretty far from conclusive that lots of options wind up meaning anything good for shareholders. In fact, over this five year stretch, shareholders received better treatment from firms with relatively low options issuance. Shareholders should not accept the alignment story; by approving compensation plans resulting in large option grants to executives and employees, they're not necessarily doing themselves a favor.

Additionally, they may be only hurting themselves by creating a class of insiders that can block a takeover and protect their jobs. Look at the options overhang on the companies in the first column on page 33; you have to wonder if some of these grants can amount to creeping management takeovers.

* *

As always, this has been one of the more challenging pieces to write. Before I ever get to do write it, however, it's a Herculean task to gather the underlying data. Fortunately, I've have a team full of Hercules clones to help clean the EDGAR-ean stables. The cast of interns was ably managed by Paula Tanabe, who kept the players on task and on time; to my delight, this is the earliest we've ever been able to complete this report. The team rotates every year, and this year I've been very fortunate to have a very deep bench: it's the second go-round on this assignment for departing interns Brian Egan and Scott Thompson, who now know more than they ever wanted to know about stock option compensation, its ramifications and where secrets reside in the financial statements. The same goes for Jesse Harlan, also tremendously efficient in his second go-round, but staying right here (and itching to work on something else!) Newcomer Brian Neuner had his eyes opened to the secrets of "option compensation in a footnote" and contributed mightily in his first few months on the job. Finally, Brenda Rappold orchestrated the reference material you see in the back of this report (which I hope you will find handy in the coming year.)

Thanks to all of the cast, especially for their unflagging good humor during the "check this again, please" phase of the stable-cleaning.

Appendix. Reference Data For S&P 500 Companies

The following section is a compendium of some of the Statement No. 123 data used in the production of this report. Pages 35 through 46 present the last three years' diluted earnings per share on both an "as reported" basis and a Statement No. 123 pro forma basis, as well as the number of options outstanding, the number of options granted, and the number of options exercised in each of those three years.

Pages 47 through 58 present the weighted average fair value of options issued in the last three years, as well as the valuation assumptions companies used in computing fair values: volatility, expected life, interest rate, and dividend rate.

Company	Continuing Operations: Diluted EPS — As Reported 2002	2001	2000	SFAS No. 123 Pro Forma 2002	2001	2000	Options Outstanding 2002	Ex. Price	2001	2000	Options Granted 2002	2001	2000	Options Exercised 2002	2001	2000
Automobiles & Components																
Cooper Tire & Rubber Co	1.51	0.25	1.31	1.46	0.18	1.24	4.89	13.39	4.71	3.81	1.33	1.28	1.59	0.92	0.04	0.03
Dana	0.39	-1.46	2.18	0.28	-1.57	2.09	17.51	20.13	15.12	13.02	3.16	2.79	3.34	0.00	0.05	0.12
Delphi	0.61	-0.66	1.88	0.53	-0.78	1.74	84.50	11.82	74.09	56.92	12.37	21.91	17.72	1.00	0.45	0.54
Ford	0.15	-3.02	3.59	0.05	-3.10	3.51	212.90	7.63	172.10	153.70	50.60	35.30	15.80	4.30	14.03	6.90
General Motors	3.35	1.77	6.68	3.00	1.38	6.26	84.78	40.62	67.02	53.49	22.31	17.04	15.41	2.80	1.72	8.47
Goodyear Tire	-6.62	-1.27	0.25	-6.86	-1.46	0.09	24.47	17.78	21.84	19.05	3.45	3.21	6.79	0.11	0.11	0.04
Harley-Davidson	1.90	1.43	1.13	1.86	1.39	1.10	8.68	13.08	8.53	10.33	1.18	1.51	1.50	0.96	3.15	2.60
Johnson Controls	6.35	5.11	5.09	6.22	5.02	5.03	5.27	42.09	4.85	5.02	1.38	1.51	1.23	0.80	1.51	0.34
Visteon	-0.68	-0.91	2.08	-0.7	-0.95	2.08	7.91	11.96	4.93	NA	3.49	5.19	NA	0.24	0.17	NA
Banks																
Amsouth Bancorporation	1.68	1.45	0.86	1.62	1.38	0.83	26.84	13.90	21.33	16.64	8.93	6.51	7.82	2.38	1.13	2.32
Bank Of America	5.91	4.18	4.52	5.64	3.96	4.34	205.72	52.40	184.55	178.57	85.84	53.07	49.32	49.06	28.20	5.14
Bank Of New York	1.24	1.81	1.92	1.15	1.73	1.87	51.43	14.03	39.30	33.49	14.36	9.80	9.49	1.61	3.63	5.62
Bank One	2.80	2.28	-0.45	2.76	2.06	-0.58	96.11	26.60	90.48	77.32	20.06	23.57	42.66	10.22	7.26	2.09
BB&T	2.70	2.12	1.53	2.64	2.07	1.49	22.68	18.31	20.68	18.68	4.73	4.20	4.75	3.41	3.16	2.69
Charter One Financial	2.45	2.10	1.81	2.33	1.99	1.71	28.57	13.27	27.49	21.94	4.64	8.18	4.40	3.21	3.08	2.36
Comerica	3.40	3.88	4.31	3.32	3.63	4.17	14.87	29.63	13.10	12.56	3.20	2.57	2.78	1.13	1.76	1.52
Fifth Third Bancorp	2.76	1.86	1.98	2.57	1.68	1.82	39.03	30.73	36.74	33.03	6.56	8.28	8.23	3.74	4.01	3.62
First Tennessee National	2.89	2.51	1.77	2.74	2.42	1.65	22.30	20.55	21.11	21.26	4.91	5.33	7.42	3.22	4.95	1.49
FleetBoston Financial	1.44	0.83	3.52	1.35	0.74	3.45	106.85	22.09	105.46	99.79	14.87	21.35	23.96	3.41	12.05	8.37
Golden West Financial	6.12	5.11	3.41	6.09	5.08	3.37	5.60	21.77	6.39	6.27	0.01	0.93	1.38	0.73	0.80	0.73
Huntington Bancshares	1.49	0.71	1.32	1.44	0.66	1.27	18.02	12.79	14.65	9.48	5.51	6.82	2.53	0.89	0.61	0.30
KeyCorp	2.27	0.37	2.30	2.23	0.31	2.24	37.68	16.08	34.25	34.29	7.92	7.38	9.35	2.35	2.21	1.93
Marshall & Ilsley Corp.	2.16	1.55	1.46	2.07	1.49	1.39	20.95	15.58	17.50	16.23	4.80	3.94	3.51	0.99	2.23	0.53
Mellon Financial Corp	1.52	0.91	1.52	1.43	0.82	1.46	33.95	14.04	28.34	26.61	9.19	8.43	7.40	1.32	3.93	5.66
National City Corp.	2.59	2.27	2.13	2.5	2.20	2.07	52.96	18.35	48.80	45.95	10.42	10.16	12.04	5.40	6.48	2.49
North Fork Bancorporation	2.58	2.05	1.39	2.54	2.03	1.38	3.36	19.15	3.71	5.28	1.22	0.45	0.35	1.50	2.00	1.24
Northern Trust	1.97	2.11	2.08	1.73	1.92	1.93	20.56	16.01	17.99	16.70	4.49	2.76	3.11	1.44	1.36	2.36
PNC Fin'l Services	4.18	1.26	4.09	4.04	1.14	4.02	15.54	40.05	12.48	11.83	4.51	4.00	4.17	0.50	2.74	2.95
Regions Fin'l Corp	2.72	2.24	2.38	2.66	2.09	2.33	18.98	20.50	17.28	8.79	3.88	9.56	2.28	1.71	0.91	0.45
Southtrust	1.85	1.61	1.43	1.83	1.59	1.42	14.62	10.53	12.56	10.81	2.65	2.44	2.17	0.45	0.69	0.58
Suntrust Banks	4.66	4.70	4.30	4.59	4.65	4.26	11.74	33.14	12.13	10.00	0.48	3.23	2.85	0.42	0.63	0.51
Synovus Financial	1.21	1.05	0.92	1.17	1.00	0.87	25.87	10.03	25.58	23.22	2.70	5.17	5.64	1.99	2.41	1.10
U.S. Bancorp	1.73	0.88	1.50	1.67	0.76	1.43	206.25	13.26	201.61	153.40	29.74	65.14	22.63	9.59	12.78	10.02
Union Planters	2.59	2.13	2.00	2.52	2.08	1.96	19.00	22.10	18.36	11.94	4.31	9.14	2.78	2.08	1.44	0.40
Wachovia Corp	2.60	1.45	0.12	2.55	1.40	-0.01	135.78	24.45	125.55	73.76	24.24	26.42	14.38	6.11	2.09	4.70
Washington Mutual	4.05	3.15	2.36	3.99	3.12	2.34	57.82	19.79	40.33	29.93	20.88	16.71	8.06	7.47	11.07	2.57
Wells Fargo & Co.	3.32	1.97	2.33	3.21	1.89	2.27	143.46	42.57	127.34	125.67	41.80	20.28	46.37	11.63	11.18	14.41
Zions Bancorp	3.44	3.15	1.86	3.23	2.85	1.68	7.48	32.62	6.46	4.73	2.09	2.09	1.99	0.65	0.61	0.41
Capital Goods																
3M	4.99	3.58	4.64	4.63	3.20	4.35	35.59	79.17	34.55	32.35	7.58	8.21	7.82	6.44	5.82	5.89
American Power Conversion	0.59	0.58	0.83	0.46	0.33	0.65	20.18	10.09	17.65	19.00	4.60	0.57	9.45	0.31	0.75	1.49
American Standard	5.04	4.04	4.36	4.74	3.81	4.14	6.35	35.24	5.92	8.26	2.27	1.54	1.30	1.65	3.61	1.18
Boeing	2.87	3.41	2.44	2.87	3.41	2.44	28.67	24.47	28.19	27.90	2.75	2.81	3.69	2.00	2.32	4.67

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Options Outstanding Ex. Price	Options Outstanding 2001	Options Outstanding 2000	Options Granted 2002	Options Granted 2001	Options Granted 2000	Options Exercised 2002	Options Exercised 2001	Options Exercised 2000
Caterpillar	2.30	2.32	3.02	2.13	2.17	2.90	38.72	26.41	32.30	26.34	8.10	7.56	6.67	1.58	1.27	0.54
Cooper Industries	2.28	2.75	3.80	2.14	2.70	3.72	7.32	38.52	4.74	3.81	2.81	1.74	1.43	0.04	0.63	0.01
Crane	0.28	1.47	2.03	0.19	1.37	1.92	6.04	17.06	5.35	4.94	1.19	1.35	1.13	0.25	0.54	0.80
Cummins	NYA	-2.66	0.20	NYA	-2.97	NA	NYA	NYA	5.90	4.01	NYA	2.07	0.94	NYA	0.07	0.01
Danaher	2.79	2.01	2.23	2.66	1.88	2.11	9.40	22.38	10.02	10.75	1.52	1.55	3.27	1.87	1.68	1.62
Deere	1.33	-0.27	2.06	1.19	-0.41	1.89	22.90	30.35	20.50	16.70	4.30	4.50	5.50	1.60	0.60	0.60
Dover	1.04	0.82	2.61	0.96	0.75	2.53	8.83	16.85	7.40	5.98	2.14	2.01	1.03	0.38	0.27	0.66
Eaton	3.92	2.39	5.00	3.73	2.17	4.75	9.60	46.67	9.90	10.20	1.10	1.20	1.50	1.00	1.00	0.30
Emerson Electric	2.52	2.40	3.30	2.48	2.36	3.25	10.41	40.86	9.09	10.15	2.11	0.45	3.10	0.59	1.22	1.09
Fluor	2.13	1.61	1.52	2.06	1.46	1.43	4.57	24.00	4.56	9.36	0.74	1.04	1.63	0.63	5.56	0.15
General Dynamics	5.18	4.65	4.48	5.04	4.54	4.40	7.66	43.56	7.07	6.57	2.25	2.42	2.96	1.51	1.77	3.67
General Electric	1.51	1.41	1.27	1.48	1.38	1.24	362.06	9.45	354.45	333.18	46.93	60.95	46.28	29.15	31.80	44.76
Goodrich	1.57	1.65	2.68	1.46	1.51	2.63	9.46	24.27	7.81	8.52	1.92	1.48	2.48	0.18	0.48	1.40
Grainger W W	2.50	1.84	2.05	2.34	1.72	1.94	9.46	33.68	8.39	5.95	2.08	3.08	1.97	0.71	0.39	0.30
Honeywell	-0.27	-0.12	2.05	-0.35	-0.23	1.96	52.01	18.15	53.88	46.00	3.00	15.48	4.51	1.69	3.12	12.12
Illinois Tool Works	3.02	2.62	3.18	2.94	2.52	3.13	12.11	27.69	13.47	13.32	0.36	2.71	3.25	1.69	2.48	1.71
Ingersoll-Rand	2.16	1.09	2.69	1.99	0.90	2.59	13.42	33.03	13.07	9.33	2.05	4.25	2.63	1.11	0.35	0.24
ITT Industries	4.06	2.39	2.94	3.83	2.09	2.81	7.89	27.93	9.43	11.86	2.11	2.08	1.94	3.63	4.42	1.74
Lockheed Martin	1.18	0.10	-1.19	1.03	-0.01	-1.27	30.63	30.76	38.40	38.58	7.05	7.02	8.45	14.23	7.02	0.66
Masco	1.33	0.42	1.31	1.3	0.38	1.28	25.51	19.00	21.91	22.19	6.08	4.10	10.12	2.12	3.48	0.54
McDermott Int'l	-12.71	-0.34	-0.37	-12.82	-0.38	-0.40	7.53	9.12	6.56	4.87	1.60	1.92	2.48	0.11	0.01	0.00
Navistar Int'l	-7.88	-0.39	2.58	-8.06	-0.53	2.47	5.25	22.38	4.83	3.81	1.81	1.29	1.47	1.33	0.14	0.62
Northrop Grumman	5.72	4.80	8.82	5.53	4.65	8.65	13.39	76.00	6.71	4.67	2.26	2.13	0.69	1.18	0.99	0.57
Paccar	3.20	1.51	3.82	3.15	1.45	3.78	3.02	32.45	3.16	3.00	0.66	0.81	0.89	0.70	0.55	0.51
Pall	0.59	0.95	1.18	0.5	0.90	1.11	7.39	18.45	8.10	7.92	0.33	3.61	0.15	0.68	1.19	0.22
Parker Hannifin	1.12	2.99	3.31	0.99	2.89	3.25	6.22	26.86	5.19	4.97	2.15	1.46	1.08	1.04	1.16	0.69
Power-One	-2.62	-2.36	0.56	-2.91	-2.65	0.45	11.10	5.13	12.21	8.59	0.60	5.03	4.27	1.00	0.42	0.75
Raytheon	1.85	0.01	1.46	1.71	-0.13	1.21	42.14	22.89	39.20	34.09	10.05	9.32	12.57	3.58	1.28	0.25
Rockwell Automation	1.20	0.68	1.81	1.17	0.50	1.68	19.78	11.63	19.70	14.00	2.72	3.31	2.52	2.12	1.88	0.56
Rockwell Collins	1.28	0.72	1.35	1.18	0.60	1.35	16.29	15.00	15.79	NA	2.00	2.99	NA	1.14	0.05	NA
Textron	2.60	1.16	1.90	2.38	0.98	1.73	14.14	34.25	10.98	12.63	5.14	0.32	4.62	0.70	0.88	0.44
Thomas & Betts	-0.14	-2.39	-3.08	-0.22	-2.47	-3.15	5.21	19.22	4.86	3.05	0.71	2.33	1.05	0.01	0.00	0.00
Tyco	-1.54	2.55	2.64	-1.75	2.34	2.42	153.63	22.88	120.25	95.02	60.01	33.73	30.36	8.16	21.54	17.24
United Technologies	4.42	3.83	3.55	4.19	3.64	3.41	48.05	32.01	43.15	42.39	10.31	8.26	8.17	4.03	6.21	9.41
Commercial Svcs & Supplies																
Allied Waste Industries	0.76	0.01	0.36	0.69	-0.07	0.29	19.76	8.40	16.72	15.45	4.56	2.40	2.20	0.34	0.69	0.38
Apollo Group	0.87	0.6	0.41	0.79	0.52	0.39	7.53	10.91	7.50	8.02	2.19	1.71	2.15	1.68	2.10	1.56
Automatic Data Processing	1.75	1.44	1.31	1.56	1.27	1.18	50.84	22.00	47.50	46.69	12.33	10.74	9.65	6.48	7.96	6.74
Avery Dennison	2.59	2.47	2.84	2.42	2.34	2.72	6.94	33.50	6.84	6.07	1.38	1.93	0.74	1.05	0.90	1.81
Block, H&R	2.31	1.49	1.27	2.13	1.39	1.20	15.91	19.82	18.91	16.88	8.82	8.61	10.12	9.66	1.02	2.06
Cendant	1.04	0.45	0.89	0.76	0.21	0.76	237.00	10.35	218.00	187.00	45.00	75.00	37.00	10.00	28.00	19.00
Cintas	1.36	1.30	1.14	1.33	1.27	1.12	5.86	11.93	5.73	5.94	0.82	0.69	0.76	0.52	0.66	0.49
Concord EFS	0.57	0.42	0.42	0.49	0.36	0.37	52.895	9.89	45.84	46.44	9.59	7.54	13.23	2.40	7.38	5.59
Convergys	0.88	0.80	1.09	0.61	0.54	0.94	17.53	7.40	15.19	14.87	3.98	3.92	4.97	1.01	2.75	1.91
Deluxe	3.36	2.69	2.34	3.32	2.64	2.28	3.53	24.21	3.55	5.37	1.25	1.07	1.22	1.15	2.68	0.00
Donnelley, R R	1.24	0.21	2.17	1.15	0.09	2.07	16.87	21.91	16.68	18.03	1.92	1.84	6.51	0.45	0.82	0.32

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Ex. Price	Options Outstanding 2001	Options Outstanding 2000	Options Granted 2002	Options Granted 2001	Options Granted 2000	Options Exercised 2002	Options Exercised 2001	Options Exercised 2000
Equifax	1.38	0.84	1.68	1.28	0.70	1.56	10.57	15.31	10.91	9.70	2.39	2.68	1.84	2.31	2.35	1.78
First Data	1.61	1.10	1.12	1.46	1.01	1.07	59.20	14.00	56.70	55.10	16.20	19.20	6.30	11.10	13.50	14.80
FiServe	1.37	1.09	0.93	1.27	1.02	0.88	11.61	10.70	13.00	12.46	1.52	2.28	1.79	2.80	1.35	2.30
Paychex	0.73	0.68	0.51	0.69	0.65	0.48	8.70	9.51	9.16	10.71	2.22	0.88	2.99	2.21	1.88	2.28
Pitney Bowes	1.81	2.08	2.18	1.72	1.98	2.08	18.92	24.00	18.42	17.39	1.75	1.95	9.37	0.53	0.44	0.81
Robert Half	0.01	0.67	1.00	-0.17	0.51	0.89	29.07	16.96	26.74	25.84	6.68	6.89	5.57	2.69	3.113	3.38
Sabre Holdings	1.50	-0.35	0.74	1.35	-0.49	0.66	14.40	38.64	9.69	15.74	4.18	0.50	13.55	1.33	3.18	0.78
TMP Worldwide	-0.96	0.61	0.46	-1.52	0.10	0.01	18.75	16.12	18.33	16.97	3.74	5.58	3.96	0.46	2.16	2.13
Waste Management	1.33	0.80	-0.16	1.19	0.67	-0.28	44.47	15.23	40.49	39.18	10.38	11.47	8.07	1.76	3.27	1.29
Consumer Durables &																
American Greetings	-1.92	-1.46	1.37	-2.05	-1.54	1.24	10.06	8.72	6.45	6.38	5.29	0.78	3.65	0.01	0.00	0.02
Black & Decker	2.84	1.33	3.34	2.62	1.13	3.12	9.38	26.91	9.09	9.56	1.28	1.28	3.89	0.77	1.26	0.16
Brunswick	1.14	0.96	2.28	1.08	0.90	2.23	9.27	20.06	10.48	8.87	1.01	2.69	1.69	2.05	0.56	0.19
Centex	6.11	4.65	4.22	5.72	4.24	3.80	7.14	22.19	6.87	7.37	1.70	2.11	2.38	1.39	1.16	1.34
Eastman Kodak	2.72	0.26	4.59	2.36	-0.01	4.41	42.28	32.05	50.46	44.85	20.16	8.58	12.53	1.58	0.62	[illegible]33
Fortune Brands	3.41	2.49	-0.88	3.31	2.39	-0.97	12.36	29.95	14.17	13.79	2.94	2.84	3.18	4.56	1.86	0.12
Hasbro	0.43	0.35	-0.82	0.32	0.29	-0.94	39.62	11.58	38.48	40.46	4.76	3.54	9.03	0.47	0.60	0.48
Jones Apparel Group	2.46	1.82	2.48	2.25	1.63	2.33	14.20	24.54	17.90	15.70	2.00	5.60	6.20	4.80	4.30	2.30
KB Home	7.15	5.50	5.24	7.00	5.23	5.10	6.45	21.80	6.25	5.74	1.96	2.14	1.62	1.60	1.46	0.31
Leggett & Platt	1.17	0.94	1.32	1.14	0.90	1.29	10.05	12.27	9.92	11.27	1.69	2.01	1.20	1.30	2.62	0.95
Liz Claiborne	2.16	1.83	1.72	2.02	1.70	1.63	8.71	18.25	7.58	7.23	3.27	3.55	3.76	1.78	2.36	1.32
Mattel	1.03	0.71	0.40	0.99	0.68	0.32	40.48	13.58	52.60	56.99	7.13	5.65	17.90	4.05	4.22	2.44
Maytag	2.44	2.13	2.63	2.33	2.02	2.30	7.76	21.44	8.67	8.17	0.83	1.62	1.70	1.10	0.43	0.24
Newell Rubbermaid	1.16	0.99	1.57	1.1	0.93	1.53	11.40	25.00	9.91	8.05	3.90	4.37	3.49	0.70	0.20	0.10
Nike	2.46	2.16	2.07	2.3	2.05	1.97	16.44	33.62	14.17	18.07	4.69	0.34	8.29	1.69	2.94	1.24
Pulte Homes Inc	7.20	6.01	5.18	7.06	5.73	5.05	6.14	19.00	6.54	5.36	1.39	1.93	1.44	1.73	0.68	1.63
Reebok	2.04	1.66	1.40	1.99	1.61	1.35	9.09	14.60	9.27	8.34	1.66	3.25	3.87	1.07	1.65	2.54
Snap-On	1.76	0.37	2.10	1.66	0.27	1.98	5.40	22.80	5.19	4.53	0.86	1.23	1.74	0.48	0.38	0.12
Stanley Works	2.10	1.81	2.22	2	1.77	1.97	11.01	24.72	9.86	9.99	1.94	1.97	4.14	0.59	0.83	0.36
Tupperware	1.54	1.04	1.29	1.42	0.93	1.19	10.72	14.75	10.50	9.37	1.30	1.58	3.82	0.34	0.24	0.12
VF Corp.	3.24	1.89	2.26	3.11	1.76	2.18	9.79	30.29	9.01	8.50	2.45	2.42	2.21	1.33	1.70	0.05
Whirlpool	3.78	0.50	5.20	3.59	0.31	5.03	5.97	51.48	6.07	6.44	1.47	1.40	2.22	1.40	1.51	0.19
Diversified Financials																
American Express	2.01	0.98	2.07	1.76	0.80	1.92	166.23	24.98	146.07	114.46	40.43	42.88	39.27	7.93	5.65	14.11
Bear Stearns	6.47	4.27	5.35	6.15	4.05	5.30	20.45	48.03	17.47	12.80	4.32	6.04	9.21	0.55	0.01	NA
Capital One Financial	3.93	2.91	2.24	3.37	2.71	1.97	52.11	27.19	50.15	36.69	6.63	21.11	4.06	1.62	6.95	3.33
Charles Schwab	0.07	0.06	0.51	-0.03	-0.06	0.43	156.00	6.59	153.00	97.00	26.00	68.00	29.00	6.00	6.00	20.00
Citigroup	2.59	2.55	2.37	2.51	2.64	2.50	380.27	20.99	390.73	399.44	90.13	76.15	154.32	40.83	61.76	137.01
Countrywide Financial Corp.	6.49	3.89	3.14	6.37	3.71	2.91	16.51	28.33	16.16	13.43	3.60	4.81	2.63	2.89	1.30	2.80
Fannie Mae	4.53	5.55	4.29	4.45	5.79	4.12	25.13	29.58	26.23	25.31	0.87	4.17	7.74	1.48	2.61	4.00
Federal Homeloan Mtg	NYA	5.96	3.39	NYA	5.92	3.36	NYA	NYA	8.72	9.04	NYA	1.44	2.02	NYA	1.59	2.34
Federated Investors, Inc	1.74	1.40	1.27	1.68	1.35	1.24	11.91	15.55	11.56	12.17	0.95	0.26	5.78	0.01	0.69	0.00
Franklin Resources	1.65	1.91	2.28	1.42	1.76	2.24	11.68	37.03	8.40	2.22	4.21	6.64	1.11	0.93	0.47	0.20
Goldman Sachs Group	4.03	4.26	6.00	3.32	3.63	5.81	94.27	52.78	84.37	57.44	15.91	29.00	19.69	1.14	0.10	0.02
J.P. Morgan Chase	0.80	0.80	2.86	0.37	0.50	2.68	411.89	16.73	359.70	242.47	85.78	162.91	50.54	9.96	31.22	33.13

	------------Continuing Operations: Diluted EPS------------ As Reported			SFAS No. 123 Pro Forma			Options Outstanding				Options Granted			Options Exercised		
Company	2002	2001	2000	2002	2001	2000	2002	Ex. Price	2001	2000	2002	2001	2000	2002	2001	2000
Janus Capital Group	0.38	1.31	2.90	0.35	1.27	2.88	9.92	8.04	8.45	13.39	1.94	0.11	16.87	0.29	5.01	3.48
Lehman Bros	3.47	4.38	6.38	2.95	4.20	6.32	83.54	25.02	68.39	54.57	26.21	21.53	25.11	9.65	6.26	9.48
MBNA	1.34	1.28	1.02	1.29	1.23	0.99	110.73	6.15	113.03	101.92	20.68	24.12	12.21	22.52	12.96	12.94
Merrill Lynch & Co	2.63	0.57	4.11	1.83	-0.38	3.73	221.89	14.78	194.45	187.06	45.37	35.14	39.84	14.87	23.56	35.67
Moody's	1.83	1.32	0.97	1.74	1.27	0.93	15.30	19.31	14.70	19.30	3.80	0.10	5.50	2.50	2.50	0.60
Morgan Stanley	2.69	3.19	4.73	2.45	2.86	4.30	163.70	19.40	151.40	137.60	22.80	24.50	25.50	7.60	8.10	17.80
Principal Financial Group	1.77	-0.08	NA	1.76	-0.08	NA	4.14	22.33	3.64	NA	1.49	3.67	NA	0.0006	0.00	NA
Providian	0.52	0.49	2.34	0.49	0.24	2.12	22.99	6.20	25.24	23.88	8.12	5.99	8.97	0.01	2.41	2.57
SLM Corporation	4.93	2.28	2.76	4.28	1.63	2.46	16.08	55.52	13.00	16.29	9.11	8.79	9.36	5.31	11.64	3.71
State Street	3.10	1.90	1.81	2.95	1.77	1.71	26.31	28.15	21.76	18.03	7.15	5.57	5.19	2.07	1.60	4.45
T. Rowe Price Associates	1.52	1.52	2.08	1.31	1.30	1.92	27.94	11.87	27.30	25.60	3.97	3.97	4.91	2.48	1.84	2.51
Energy																
Amerada Hess	-2.48	10.25	11.38	-2.63	10.10	11.19	4.38	57.81	4.87	4.30	0.05	1.67	0.87	0.49	1.05	1.08
Anadarko Petroleum	3.21	-0.73	4.25	3.13	-0.90	4.05	15.30	32.53	14.60	14.40	1.40	1.00	7.40	0.60	0.60	6.30
Apache	3.60	4.73	4.96	3.45	4.56	4.83	5.55	30.56	5.63	5.01	0.89	1.20	1.02	0.74	0.28	1.02
Ashland	1.83	5.77	4.10	1.77	5.73	4.04	7.48	31.34	6.74	6.38	1.21	1.00	0.51	0.41	0.57	0.20
Baker Hughes	0.66	1.30	0.31	0.6	1.22	0.25	10.87	21.35	9.87	10.65	2.06	1.85	2.15	0.88	2.29	2.47
BJ Services	1.04	2.09	0.70	1.03	2.04	0.66	7.34	8.75	4.42	4.95	4.11	1.34	0.15	0.44	1.74	3.86
Burlington Resources	2.25	2.69	3.12	2.2	2.63	3.06	7.16	31.80	6.86	6.58	1.01	1.64	1.43	0.40	1.05	2.91
Chevron Texaco Corp	1.07	3.70	7.21	1.02	3.62	7.17	24.62	73.01	22.62	20.87	3.29	3.78	3.76	1.82	8.21	1.46
Conoco Phillips	1.47	5.57	7.26	1.34	5.51	7.21	43.11	24.66	16.43	9.86	28.83	9.04	1.30	2.03	2.37	1.22
Devon Energy	0.32	0.34	5.50	0.22	0.23	5.36	11.23	29.33	8.18	7.36	2.81	2.60	1.62	0.90	1.50	2.49
EOG Resources	0.65	3.30	3.24	0.53	3.20	3.14	7.84	19.90	7.01	7.06	1.61	1.63	1.32	0.87	1.56	6.73
Exxon Mobil	1.61	2.18	2.27	1.59	2.14	2.23	247.00	16.18	265.70	248.68	0.00	34.72	36.22	18.33	16.95	28.71
Halliburton	-0.80	1.28	0.42	-0.86	1.18	0.33	18.50	11.39	17.10	14.70	2.60	3.60	1.70	0.03	0.70	3.60
Kerr-McGee	-6.09	4.65	8.13	-6.24	4.57	8.06	5.41	46.78	3.43	3.04	2.54	1.02	0.72	0.11	0.53	0.43
Nabors Industries	0.81	2.24	0.9	0.6	2.19	0.45	23.67	12.68	19.26	19.07	5.50	0.88	6.20	0.81	0.56	9.66
Noble Corp	1.57	1.97	1.22	1.43	1.85	1.13	9.19	19.99	8.49	7.34	1.63	1.97	1.89	0.78	0.66	2.57
Occidental	3.07	3.15	4.22	3.04	3.11	4.18	26.97	21.12	25.39	18.22	4.90	11.04	5.58	3.10	3.40	0.09
Rowan Companies	0.90	0.80	0.74	0.87	0.77	0.72	4.76	9.00	4.86	3.36	0.25	2.08	0.90	0.31	0.55	0.69
Schlumberger	-4.18	0.91	1.27	-4.45	0.67	1.09	36.87	30.02	32.84	31.21	7.31	4.11	5.64	2.30	1.44	5.45
Sunoco	-0.62	4.85	4.70	-0.62	4.81	4.67	4.69	27.51	4.88	5.56	0.73	0.75	0.70	0.82	1.40	0.09
Transocean	-7.42	0.86	0.50	-7.49	0.82	0.47	15.38	18.12	13.46	4.37	2.16	2.37	1.64	0.10	1.29	0.50
Unocal	1.34	2.43	2.93	1.21	2.38	2.91	15.78	27.98	11.00	11.34	1.71	3.44	2.71	0.79	0.55	0.31
USX-Marathon Group	1.72	4.26	1.35	1.72	4.24	1.34	8.06	27.58	6.73	6.11	1.76	1.64	1.80	0.24	0.96	0.06
Food & Drug Retailing																
Albertson's	2.17	1.22	1.78	2.09	1.14	1.72	30.25	23.99	28.05	25.29	5.31	6.41	8.68	0.72	1.30	0.29
CVS	1.75	1.00	1.83	1.62	0.86	1.76	23.39	18.31	17.63	14.65	8.02	5.38	6.96	0.52	1.08	3.51
Kroger	1.56	1.26	1.04	1.51	1.22	0.99	66.20	6.27	59.70	62.60	14.50	6.10	0.80	6.80	8.80	8.20
Safeway	1.20	2.44	2.13	1.1	2.36	2.07	37.94	10.64	38.65	37.18	5.04	5.46	8.62	3.02	2.92	10.44
SuperValu	1.91	1.48	0.55	1.84	1.44	0.49	13.01	17.44	13.17	14.41	2.89	1.22	4.24	2.90	1.78	0.51
Sysco	1.01	0.88	0.68	0.96	0.86	0.67	48.16	10.32	21.05	19.63	30.51	5.82	4.95	2.66	3.93	2.63
Walgreen	0.99	0.86	0.76	0.93	0.81	0.74	34.30	7.28	36.26	39.38	2.89	5.35	17.04	3.53	5.53	5.06
Winn-Dixie Stores	1.35	0.55	-1.47	1.35	0.55	-1.47	2.63	15.45	2.23	1.33	0.55	0.98	1.83	0.04	0.005	0.05
Food Beverage & Tobacco																

Company	Continuing Operations: Diluted EPS — As Reported 2002	2001	2000	SFAS No. 123 Pro Forma 2002	2001	2000	Options Outstanding 2002	Ex. Price	2001	2000	Options Granted 2002	2001	2000	Options Exercised 2002	2001	2000
Altria Group	5.21	3.88	3.75	5.15	3.78	3.69	114.32	30.33	137.13	133.00	3.25	35.64	41.54	24.12	30.28	5.26
Anheuser-Busch	2.20	1.89	1.69	2.09	1.81	1.64	74.11	20.15	68.90	59.17	14.18	13.90	13.01	8.82	3.99	10.15
Archer Daniels Midland	0.78	0.58	0.45	0.7722	0.58	0.45	10.58	12.01	10.58	10.97	2.63	0.04	6.08	0.72	0.03	0.01
Brown-Forman	3.33	3.40	3.18	3.27	3.35	3.14	2.07	48.00	1.79	1.40	0.36	0.41	0.80	0.08	0.02	0.01
Campbell Soup	1.28	1.55	1.65	1.24	1.52	1.62	30.01	17.52	17.37	24.02	15.18	1.36	6.11	0.83	2.43	1.35
Coca-Cola	1.60	1.60	0.88	1.6	1.51	0.80	159.00	31.09	141.00	112.00	29.00	45.00	32.00	3.00	7.00	12.00
Coca-Cola Enterprises	1.07	-0.75	0.54	0.97	-0.86	0.46	59.94	8.03	57.88	46.01	7.93	16.28	1.21	4.22	3.00	1.21
Conagra Foods	1.47	1.33	0.80	1.44	1.30	0.76	31.90	16.23	28.80	25.60	7.30	11.60	6.00	2.30	6.10	1.80
Coors, Adolf	4.42	3.31	2.83	4.09	2.86	2.57	5.06	40.17	3.82	2.76	1.87	1.66	1.18	0.36	0.33	0.90
General Mills	1.35	2.28	2.00	1.14	2.15	1.89	71.08	27.64	63.50	58.29	14.57	11.60	11.44	6.57	5.65	5.68
Heinz	2.36	1.41	2.47	2.24	1.31	2.40	31.31	24.93	30.24	29.72	4.71	4.81	0.35	2.56	3.40	0.86
Hershey Foods	2.93	1.50	2.42	2.84	1.45	2.37	6.96	39.53	8.01	8.30	1.36	0.78	2.40	2.18	0.92	0.93
Kellogg	1.75	1.18	1.45	1.65	1.12	1.40	38.20	27.00	37.00	23.40	9.20	17.10	6.40	5.20	1.30	0.10
McCormick & Company	1.26	1.05	0.99	1.2	0.99	0.96	14.60	13.36	13.00	11.00	3.80	4.40	3.10	1.90	2.20	0.80
Pepsi Bottling Group	1.46	1.03	0.77	1.32	0.91	0.69	37.40	11.63	39.70	33.20	6.40	10.20	13.20	8.10	1.80	0.20
Pepsico	1.85	1.47	1.42	1.65	1.30	1.31	190.43	23.32	176.92	170.64	37.38	40.43	28.66	19.56	29.06	37.04
RJ Reynolds Tobacco	4.64	4.48	3.46	4.55	4.43	3.43	2.88	28.65	4.39	6.10	0.01	NA	NA	1.37	1.48279	2.25762
Sara Lee	1.23	1.87	1.27	1.16	1.80	1.18	80.62	16.28	77.99	89.61	15.70	5.41	37.78	10.11	8.53	4.64
UST	-1.61	2.97	2.70	-1.63	2.95	2.66	12.83	27.75	14.26	17.54	0.75	1.56	3.12	2.01	4.67	0.80
Wrigley, William Jr	1.78	1.61	1.45	1.73	1.58	1.43	6.28	40.99	4.65	2.70	2.01	2.06	1.66	0.32	0.06	NA
Health Care Equipment &																
Aetna	2.57	-2.03	-0.90	2.36	-2.11	-1.77	28.28	27.82	32.26	31.71	5.28	5.30	5.63	8.39	2.08	1.57
AmeriSource Bergen	3.16	2.10	1.90	3.06	1.75	1.79	7.80	33.00	8.76	3.63	2.17	3.22	1.13	3.05	1.33	0.92
Anthem Inc	4.51	0.54	NA	4.42	0.53	NA	5.86	27.36	1.46	NA	1.58	1.48	NA	0.88	0.00	NA
Applera Corp - Applied	0.78	0.96	0.86	0.31	0.52	0.65	34.04	11.44	27.92	23.62	9.17	7.82	9.00	1.13	2.41	3.15
Bard, C R	2.94	2.75	2.09	2.71	2.57	1.94	3.98	32.58	3.71	4.21	0.92	1.38	0.83	0.52	1.70	0.40
Bausch & Lomb	1.34	0.78	1.49	1.07	0.54	1.25	7.06	35.81	6.07	4.97	1.86	2.07	1.47	0.07	0.11	0.61
Baxter Int'l	1.67	1.09	1.24	1.42	0.82	1.14	69.83	25.46	65.71	49.00	11.83	23.86	19.04	4.11	5.23	5.71
Becton, Dickinson	1.79	1.63	1.49	1.66	1.51	1.38	30.39	13.53	28.27	30.52	5.46	4.64	3.73	2.57	5.35	2.29
Biomet	0.88	0.73	0.65	0.86	0.71	0.64	8.39	12.29	8.71	9.41	1.72	2.37	3.21	1.67	2.69	2.45
Boston Scientific	0.90	-0.13	0.91	0.8	-0.23	0.83	42.11	17.05	43.98	44.57	5.33	6.01	18.44	5.38	2.48	1.35
Cardinal Health	2.45	1.88	1.60	2.29	1.70	1.54	37.10	23.40	33.30	37.40	8.70	7.00	10.40	4.50	10.30	6.50
CIGNA	-2.83	6.59	6.08	-3.18	6.27	5.85	14.35	70.19	13.09	11.86	4.12	3.47	4.89	1.70	1.68	3.26
Guidant	2.00	1.58	1.21	1.69	1.20	0.91	49.84	25.31	52.11	35.08	1.15	20.70	9.57	0.96	1.88	5.55
HCA	1.59	1.65	0.39	1.3	1.59	0.29	48.97	24.20	50.23	51.23	9.05	8.38	7.61	9.17	7.63	6.65
HCR Manor Care	1.33	0.66	0.38	1.26	0.60	0.35	6.65	20.34	6.06	6.38	1.01	2.54	1.64	0.23	2.16	0.51
Health Management Assoc	0.97	0.76	0.68	93.00%	0.72	0.64	19.21	4.41	20.58	21.83	1.81	2.80	3.81	2.85	2.55	1.81
Humana	0.85	0.70	0.54	0.83	0.68	0.49	10.53	8.76	10.46	11.39	1.59	0.94	1.09	0.97	0.24	0.27
IMS Health	0.93	0.46	0.39	0.84	0.30	0.05	34.57	16.20	32.13	45.57	6.43	4.27	24.92	0.99	14.57	8.19
McKesson HBOC	1.43	-0.15	0.65	0.88	-0.63	0.29	63.20	16.73	60.73	56.28	9.59	11.60	24.65	3.66	1.15	1.21
Medtronic	0.80	0.85	0.89	0.67	0.76	0.82	56.66	16.44	42.27	33.92	18.98	12.29	14.43	2.91	2.79	3.28
Millipore	1.67	1.32	1.40	1.37	1.08	1.25	4.64	30.44	5.84	5.71	0.12	1.93	1.66	0.49	1.62	1.22
Quest Diagnostics	3.23	1.88	1.11	2.87	1.63	0.90	8.92	18.70	8.70	9.25	2.05	2.41	1.50	1.54	2.58	3.32
Quintiles Transnational	0.69	-1.49	-0.29	0.55	-1.71	-0.62	33.66	11.26	29.88	27.16	7.31	8.40	15.34	0.44	2.51	0.51
St. Jude Medical	1.51	0.97	0.75	1.33	0.82	0.65	29.69	16.66	28.68	26.54	5.04	6.37	7.46	3.31	3.47	2.27
Stryker	1.70	1.34	1.10	1.61	1.28	1.05	12.40	13.19	12.20	11.20	2.00	2.00	2.80	1.50	0.80	1.10

	Continuing Operations: Diluted EPS															
	As Reported			SFAS No. 123 Pro Forma			Options Outstanding				Options Granted			Options Exercised		
Company	2002	2001	2000	2002	2001	2000	2002	Ex. Price	2001	2000	2002	2001	2000	2002	2001	2000
Tenet Healthcare	2.04	1.39	0.72	1.91	1.28	0.61	40.40	15.29	46.13	52.96	12.87	10.76	12.25	17.83	17.17	1.82
United Health Group	4.25	2.79	2.19	3.93	2.54	1.96	43.20	27.00	38.34	38.81	12.52	8.33	8.52	6.61	7.72	12.33
Well Point Health	4.64	3.15	2.64	4.29	2.90	2.44	16.74	34.06	14.71	10.65	6.01	7.29	4.37	4.56	2.40	3.82
Zimmer Holdings	1.31	0.77	0.91	1.25	0.70	0.87	11.04	18.94	10.73	NA	1.83	2.24	NA	1.26	0.13	NA
Hotels Restaurants & Leisure																
Carnival	1.73	1.58	1.60	1.69	1.54	1.60	11.83	14.35	12.77	8.84	0.03	6.58	2.91	0.40	2.22	0.24
Darden Restaurants	1.30	1.06	0.89	1.21	0.99	0.85	26.92	8.36	26.13	26.35	5.78	5.38	5.59	4.31	4.67	1.73
Harrah's Entertainment	2.86	1.81	-0.09	2.68	1.74	-0.22	8.81	19.40	8.68	12.76	2.91	0.77	3.11	2.51	3.24	2.97
Hilton Hotels	0.53	0.45	0.73	0.48	0.41	0.69	36.89	9.86	32.53	28.28	7.47	5.99	7.77	1.46	0.34	0.21
Int'l Game Technology	3.21	2.80	2.00	3.02	2.67	1.96	5.96	27.29	4.73	5.12	1.63	2.43	0.46	2.54	2.75	0.72
Marriott	1.74	0.92	1.89	1.52	0.73	1.71	37.50	22.00	38.30	30.00	1.40	13.40	0.60	1.60	4.20	3.90
McDonald's	0.77	1.25	1.46	0.57	1.13	1.36	198.90	14.91	192.90	175.80	26.30	38.60	26.50	13.10	11.90	10.80
Starbucks	0.54	0.46	0.25	0.45	0.36	0.18	40.46	9.29	43.01	41.89	10.20	9.91	9.41	9.83	6.29	8.94
Starwood	1.20	0.73	1.96	0.84	0.40	1.67	44.81	24.30	32.87	28.17	15.64	8.28	10.61	1.44	1.69	1.68
Wendy's Int'l	1.89	1.65	1.44	1.8	1.58	1.37	11.44	21.88	12.15	12.27	3.47	2.91	3.20	3.55	2.26	1.33
Yum!Brands	1.88	1.62	1.39	1.76	1.52	1.28	49.63	14.06	54.452	53.36	6.97	10.02	15.72	8.88	3.63	3.66
Household & Personal Prods																
Alberto-Culver	2.32	1.91	1.83	2.21	1.81	1.75	5.37	20.20	5.53	4.95	1.73	1.72	1.59	1.82	0.85	0.19
Avon Products	2.22	1.79	2.02	2.10	1.68	1.95	11.34	32.44	10.55	9.58	2.86	2.73	3.42	2.00	1.63	1.70
Clorox	1.37	1.36	1.64	1.26	1.21	1.56	15.21	23.00	13.70	15.06	3.79	3.08	3.10	1.59	1.08	1.38
Colgate-Palmolive Co	2.19	1.89	1.70	2.12	1.81	1.60	43.05	32.00	40.93	39.14	6.23	7.84	9.76	3.05	5.57	9.36
Gillette	1.14	0.86	0.77	1.04	0.75	0.55	78.54	21.41	71.05	58.97	14.47	18.13	11.40	3.79	2.49	2.07
Kimberly Clark	3.24	3.02	3.31	3.1	2.88	3.21	30.31	42.34	26.67	23.94	5.74	5.87	5.80	1.63	2.43	2.88
Procter & Gamble	3.09	2.07	2.47	2.77	1.85	2.34	120.16	29.07	104.20	82.74	25.04	28.40	14.36	8.15	5.71	7.40
Insurance																
ACE Limited	0.19	-0.64	2.31	0.06	-0.73	2.24	19.31	40.01	17.07	15.90	5.22	3.82	4.21	2.23	1.65	1.83
AFLAC	1.55	1.28	1.26	1.48	1.22	1.21	23.76	7.53	25.26	25.98	2.06	2.44	5.62	3.48	3.04	6.64
Allstate	1.60	1.60	2.95	1.54	1.56	2.92	31.96	20.42	25.54	22.30	8.51	6.26	5.98	1.26	2.70	3.26
AMBAC Financial Group	3.97	3.97	3.41	3.85	3.85	3.33	6.52	23.58	6.22	5.69	1.54	1.76	1.80	1.13	1.18	1.33
American Int'l Group	2.10	2.07	2.52	2.08	2.02	2.50	54.21	35.04	54.30	38.17	5.68	8.77	2.18	4.24	6.21	5.80
AON	1.64	0.53	1.82	1.56	0.50	1.76	24.48	20.00	21.30	16.16	5.55	7.65	6.81	0.88	1.75	1.17
Chubb	1.29	0.63	4.01	0.97	0.37	3.76	19.86	49.63	18.38	16.68	4.37	3.76	5.83	2.28	1.74	3.24
Cincinnati Financial Cp	1.46	1.19	0.73	1.4	1.13	0.66	7.11	21.37	6.60	6.15	1.11	1.13	1.29	0.49	0.56	0.52
Hartford Finl	3.97	2.27	4.34	3.76	2.05	4.18	20.17	37.32	18.94	16.97	3.80	4.24	5.37	2.06	1.79	3.89
Jefferson-Pilot	3.04	3.33	3.28	2.96	3.26	3.23	9.95	26.63	9.49	7.64	1.44	2.22	1.33	0.71	0.13	0.39
John Hancock	1.70	1.99	2.59	1.51	1.87	2.58	23.37	14.74	13.59	4.31	11.15	11.19	4.62	0.97	0.89	0.00
Lincoln National	0.49	3.05	3.19	0.31	2.79	3.03	18.61	31.89	21.01	21.70	2.20	3.37	10.86	2.55	3.24	1.56
Loews	4.49	-2.75	9.44	4.47	-2.76	9.44	0.83	37.32	0.54	0.26	0.32	0.28	0.26	0.01	11.90	NA
Marsh & Mclennan	2.45	1.70	2.05	2.18	1.50	1.91	82.13	23.16	70.07	62.27	21.01	15.73	14.37	7.22	6.52	10.80
MBIA	3.98	3.91	3.55	3.98	3.85	3.50	9.53	55.54	8.33	7.93	1.85	1.27	0.88	0.48	0.74	0.94
Metlife	1.58	0.62	1.49	1.52	0.59	1.49	16.27	29.95	11.11	NA	7.28	12.26	NA	0.01	NA	NA
MGIC Investments	6.04	5.93	5.05	5.94	5.80	4.95	3.59	34.46	3.34	3.38	0.82	0.53	0.95	0.52	0.56	1.08
Progressive	2.99	1.83	0.21	2.92	1.76	0.15	11.95	15.11	12.68	13.58	1.19	2.01	3.26	1.46	2.44	2.04
Prudential Financial	1.36	0.07	NA	1.31	0.06	NA	19.12	27.50	11.21	NA	10.37	11.36	NA	0.05	0.00	NA

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Ex. Price	2001	2000	Options Granted 2002	2001	2000	Options Exercised 2002	2001	2000
Safeco	2.33	-8.18	0.80	2.22	-8.21	0.77	5.63	26.50	2.78	2.92	3.29	0.89	0.73	0.25	0.32	0.06
St Paul Companies	1.06	-4.84	4.14	0.89	-4.96	4.12	19.02	29.12	18.27	14.31	4.41	7.33	6.54	0.97	1.55	3.37
Torchmark	3.18	3.11	2.82	3.12	2.81	2.78	9.69	25.96	8.73	8.53	1.17	4.49	1.39	0.20	4.26	0.52
Travelers Property Casualty	0.23	1.38	1.71	0.15	1.32	1.64	76.12	8.54	0.00	NA	78.80	0.00	NA	1.19	NA	NA
UnumProvident	1.68	2.23	2.23	1.62	2.18	2.20	19.23	17.29	18.20	16.20	3.48	3.50	5.30	1.00	0.91	0.61
XL Capital	2.88	-4.55	4.03	2.49	-4.86	3.83	11.20	51.17	9.19	8.16	3.46	3.09	0.58	1.01	1.94	2.52
Materials																
Air Products & Chemicals	2.36	2.33	0.57	2.18	2.19	0.45	25.45	27.55	22.43	20.45	5.45	4.61	3.67	2.76	3.04	1.06
Alcoa	0.58	1.05	1.81	0.45	0.84	1.56	81.60	26.77	73.50	74.80	17.30	28.90	31.30	7.10	29.00	24.30
Allegheny Technologies	-0.82	-0.31	1.60	-0.86	-0.38	1.51	7.92	0.00	5.08	4.48	3.14	0.85	0.30	0.00	0.03	0.20
Ball	2.77	-1.85	1.07	2.7	-1.92	1.03	3.21	17.53	3.78	4.31	0.56	0.98	0.76	1.03	1.40	0.18
Bemis	3.08	2.64	2.44	3.06	2.62	2.37	1.29	23.91	1.25	1.24	0.07	0.14	0.41	0.03	0.13	0.38
Boise Cascade	-0.03	-0.96	2.73	-0.21	-1.17	2.62	8.92	23.78	6.96	5.84	2.04	1.96	1.79	0.22	0.71	0.17
Dow Chemical	-0.44	-0.46	1.85	-0.54	-0.53	1.70	75.68	21.74	71.99	69.03	13.26	12.29	17.72	7.78	7.48	5.96
Du Pont	1.84	4.15	2.19	1.67	4.06	2.10	92.26	25.19	71.30	64.65	24.61	12.45	14.59	2.33	4.91	3.00
Eastman Chemical	1.02	-2.33	3.94	0.88	-2.43	3.82	8.51	39.00	7.01	5.80	1.86	1.61	1.26	0.06	0.33	0.20
Ecolab	1.62	1.45	1.58	1.52	1.37	1.52	11.93	20.54	12.43	11.88	2.46	2.67	2.77	2.22	1.56	2.19
Engelhard	1.31	1.71	1.31	1.27	1.66	1.25	11.52	18.09	12.92	17.69	1.35	1.32	1.61	2.70	5.90	0.14
Freeport McMoran	0.89	0.53	0.26	0.83	0.49	0.21	15.94	11.18	15.71	15.07	3.71	1.38	1.97	1.05	0.06	0.15
Georgia Pacific	-0.80	-2.09	1.94	-0.91	-2.22	1.74	22.21	21.32	20.15	22.52	3.10	2.03	12.74	0.20	3.50	0.56
Great Lakes Chemical	0.94	-5.76	2.42	0.86	-5.82	2.35	3.90	23.44	3.30	3.30	0.90	0.80	0.80	0.00	0.00	0.10
Hercules	-0.45	-0.98	0.56	-0.56	-1.16	0.34	18.40	11.28	19.02	17.23	2.03	2.81	3.61	0.00	0.23	0.03
Int'l Flav. & Frag.	1.84	1.20	1.22	1.67	1.05	1.10	9.66	18.42	8.36	9.60	2.90	2.04	5.76	1.36	0.29	0.08
Int'l Paper	0.61	-2.37	0.82	0.52	-2.48	0.74	37.15	34.62	29.11	23.86	11.93	7.40	9.53	1.35	0.34	1.05
Louisiana-Pacific	-0.21	-1.64	-0.13	-0.23	-1.71	-0.21	6.37	0.00	4.93	3.79	1.89	1.73	1.12	0.00	0.06	0.01
MeadWestVaco Corp	-0.01	0.87	2.53	-0.02	0.81	2.48	17.58	26.37	7.23	6.21	1.09	1.41	1.08	1.25	0.29	0.51
Monsanto Co.	0.49	1.13	0.68	0.38	0.97	0.24	19.51	20.04	22.82	22.57	0.51	1.59	22.61	3.15	0.02	0.00
Newmont Mining (Hldg. Co.)	0.39	-0.28	-0.45	0.36	-0.28	-0.59	13.11	18.00	12.31	12.67	1.80	1.44	1.50	3.80	0.40	0.11
Nucor	2.07	1.40	3.75	2.01	1.45	3.80	1.25	46.07	1.15	0.99	0.46	0.47	0.48	0.35	0.21	0.01
Pactiv	1.37	1.03	0.70	1.31	0.97	0.64	14.19	12.79	13.43	12.39	2.29	2.51	2.99	0.42	0.03	NA
Phelps Dodge	-3.54	-4.19	0.72	-3.7	-4.34	0.56	8.93	30.24	9.12	8.18	0.80	1.42	1.45	0.01	0.01	0.04
PPG Industries	-0.36	2.29	3.57	-0.5	2.15	3.44	14.81	49.14	14.51	13.19	2.61	2.70	2.05	1.23	0.87	0.30
Praxair	3.33	2.64	2.25	2.33	2.44	2.08	12.90	47.71	15.50	14.55	1.32	4.52	3.05	0.12	3.44	1.00
Rohm & Haas	0.98	-0.31	1.34	0.89	-0.40	1.30	11.59	21.80	8.04	5.70	4.47	2.91	1.06	0.69	0.45	0.73
Sealed Air	-4.30	1.22	1.93	-4.3	1.22	1.93	0.34	32.85	0.37	0.40	NA	NA	NA	0.03	0.02	0.02
Sigma-Aldrich	2.54	1.87	1.66	2.4	1.85	1.45	3.77	30.88	3.57	4.36	1.11	0.12	1.34	0.85	0.82	0.86
Temple Inland	1.25	2.26	3.83	1.08	2.18	3.71	4.34	50.00	3.58	2.76	1.01	1.09	0.97	0.08	0.14	0.09
USX-U.S. Steel Group	0.62	-2.45	-0.24	0.58	-2.48	-0.26	6.17	0.00	4.48	3.48	1.83	1.09	0.92	0.00	0.00	0.00
Vulcan Materials	1.86	2.17	2.16	1.81	2.13	2.14	6.75	21.72	5.94	5.16	1.07	1.09	1.24	0.20	0.25	0.09
Weyerhaeuser	1.09	1.61	3.72	0.95	1.52	3.65	13.85	47.45	10.07	8.72	3.03	2.29	1.95	1.78	0.82	0.37
Worthington Industries	0.08	0.42	1.06	0.06	0.40	1.05	5.42	12.10	5.84	4.34	0.00	1.85	1.01	0.14	0.00	0.36
Media																
AOL Time Warner	-10.01	-1.11	0.43	-10.24	-1.43	0.19	657.44	6.31	627.32	382.85	115.03	193.26	67.21	49.79	108.86	44.17
Clear Channel Comm	1.18	-1.93	0.57	1.1	-2.02	0.50	42.94	21.00	47.15	40.11	0.26	11.39	3.54	2.51	2.93	1.92
Comcast Corp.	-0.25	0.23	2.16	-0.38	0.10	2.05	128.47	8.99	55.52	49.62	16.62	10.08	15.30	2.39	3.36	4.81

Company	Continuing Operations: Diluted EPS — As Reported 2002	2001	2000	SFAS No. 123 Pro Forma 2002	2001	2000	Options Outstanding 2002	Ex. Price	2001	2000	Options Granted 2002	2001	2000	Options Exercised 2002	2001	2000
Dow Jones	2.40	1.14	-1.35	2.2	0.98	-1.46	7.78	34.82	6.18	4.59	2.48	2.23	1.32	0.36	0.34	0.55
Gannett	4.31	3.12	3.63	4.11	2.98	3.53	23.84	42.41	20.53	16.77	5.81	5.95	5.71	2.03	1.44	0.85
Interpublic	0.26	-1.45	1.06	0.16	-1.63	0.96	42.34	14.00	38.31	34.94	7.90	10.05	6.38	2.83	5.23	3.66
Knight-Ridder	3.33	2.16	3.53	3.15	1.98	3.24	10.44	45.79	10.00	10.13	2.12	2.14	3.58	1.42	1.60	0.45
McGraw-Hill Companies	2.96	1.92	2.41	2.71	1.73	2.29	17.52	39.66	14.58	12.21	4.99	4.81	4.15	1.70	2.09	1.85
Meredith	1.79	1.39	1.35	1.67	1.29	1.24	6.46	13.01	6.32	6.13	0.89	1.16	0.86	0.64	0.61	0.32
New York Times	1.94	1.26	2.32	1.63	0.97	2.06	29.06	26.00	26.39	25.00	5.49	5.46	5.90	2.63	2.99	1.97
Omnicom Group	3.44	2.70	2.73	3.12	2.47	2.62	19.13	44.56	17.74	9.55	2.29	9.28	2.45	0.63	1.06	1.20
Tribune Co.	1.80	0.28	0.99	1.56	0.10	0.82	44.57	30.63	41.94	38.13	13.57	9.03	8.01	9.69	4.50	4.17
Univision Communications	0.34	0.23	0.49	0.2	0.08	0.37	20.20	14.61	19.46	18.29	3.11	3.87	3.60	2.06	2.66	2.43
Viacom	1.24	-0.13	-0.30	1.13	-0.21	-0.39	154.93	17.38	137.48	117.18	27.59	22.21	11.15	20.35	10.59	10.77
Walt Disney	0.60	0.11	0.57	0.45	-0.03	0.46	216.00	18.02	188.00	162.00	50.00	43.00	49.00	2.00	9.00	28.00
Pharmaceuticals & Biotech																
Abbott Labs	1.78	0.99	1.78	1.65	0.88	1.69	99.68	28.09	86.27	77.09	24.69	23.12	18.92	10.07	12.57	11.39
Allergan	0.49	1.69	1.61	0.23	1.49	1.47	11.75	26.62	10.83	7.77	2.45	4.57	2.18	0.90	1.30	3.89
Amgen	-1.21	1.03	1.05	-1.37	0.86	0.95	103.00	15.90	94.40	98.70	17.30	18.60	13.10	26.20	20.60	28.20
Biogen	1.31	1.78	2.16	0.99	1.47	1.90	19.21	13.05	17.76	16.92	3.96	3.84	2.73	1.80	2.08	3.25
Bristol-Myers Squibb	1.05	1.04	1.92	0.92	0.91	1.81	149.20	21.64	129.31	128.84	40.11	27.97	20.85	7.35	13.92	17.61
Chiron	0.94	0.90	0.08	0.61	0.64	-0.08	25.99	17.11	22.10	18.88	7.09	7.02	6.85	1.35	3.19	3.88
Forest Laboratories	1.82	1.18	0.64	1.47	0.93	0.51	16.34	12.87	16.99	19.38	2.44	4.66	3.31	2.70	6.84	2.66
Genzyme Corporation	0.81	0.19	0.68	0.55	0.00	0.53	29.86	14.76	25.36	24.16	6.95	6.69	7.93	1.20	4.95	6.18
Johnson & Johnson	2.16	1.84	1.61	2.06	1.76	1.55	189.74	19.64	167.22	193.99	48.07	8.98	46.46	21.01	30.62	27.13
King Pharmaceuticals	NYA	0.99	0.39	NYA	0.95	0.28	NYA	NYA	4.65	5.88	NYA	0.92	1.74	NYA	1.97	5.17
Lilly, Eli & Co	2.50	2.58	2.79	2.2	2.39	2.70	76.06	21.18	67.10	45.13	14.13	26.88	1.32	3.36	4.30	9.24
Medimmune	-4.40	0.68	0.66	-4.78	0.32	0.42	28.60	2.08	20.99	21.09	6.10	4.88	7.36	2.60	3.10	7.52
Merck & Co	3.14	3.14	2.90	2.93	2.97	2.75	218.11	28.82	197.20	176.38	37.81	36.77	32.95	11.05	11.60	30.64
Pfizer	1.47	1.22	0.59	1.39	1.13	0.46	431.98	14.26	413.92	395.61	73.87	79.16	65.86	43.14	54.08	130.76
Schering-Plough	1.34	1.32	1.64	1.29	1.27	1.60	54.00	11.64	50.00	46.00	8.00	8.00	14.00	1.00	2.00	9.00
Watson Pharmaceuticals	1.64	1.07	1.65	1.35	0.95	1.53	12.55	10.79	12.41	7.97	1.80	5.97	2.71	0.36	0.84	1.20
Wyeth	3.33	1.72	-0.69	3.11	1.57	-0.80	122.81	30.09	100.00	82.75	32.91	28.36	16.50	7.23	8.55	15.12
Real Estate																
Apartment Investment &	0.94	0.17	0.46	0.85	0.13	0.39	9.27	36.05	8.32	8.24	2.07	1.13	0.22	1.05	0.55	0.59
Equity Office Properties	1.75	1.64	1.62	1.73	1.59	1.58	20.50	23.00	16.29	13.22	6.54	6.79	3.92	1.74	3.28	3.59
Equity Residential	1.18	0.85	1.01	0.74	0.83	0.99	12.81	20.36	12.17	12.75	2.26	2.84	2.17	1.43	3.13	1.16
Plum Creek Timber Co.	1.26	2.58	1.42	1.26	2.56	1.40	2.03	16.66	2.62	6.73	0.48	0.37	0.86	1.02	1.88	0.90
Simon Property Group	1.93	0.87	1.16	1.93	0.87	1.16	2.51	23.44	3.18	2.51	0.00	1.09	0.73	0.67	0.37	
Retailing																
AutoNation	1.19	0.73	0.91	1.13	0.65	0.79	53.50	11.43	57.60	57.20	6.00	8.00	12.50	7.00	0.90	0.60
AutoZone	4.00	1.54	2.00	3.91	1.48	1.93	6.28	25.26	8.46	10.77	1.13	0.91	1.96	2.62	2.14	0.52
Bed Bath & Beyond	0.74	0.59	0.46	0.67	0.53	0.41	23.12	7.25	24.17	26.22	3.44	6.15	5.53	3.55	7.08	1.98
Best Buy	1.77	1.24	1.09	1.61	1.11	1.01	27.49	6.88	26.37	25.57	9.38	8.07	4.56	6.85	5.72	6.26
Big Lots	0.66	-0.25	0.87	0.61	-0.31	0.83	9.41	12.16	10.07	10.80	1.93	2.50	2.47	1.32	1.78	0.75
Circuit Cty Group	0.92	0.73	-1.60	0.84	0.67	1.56	11.99	15.45	8.72	7.38	4.42	4.28	1.56	0.54	1.53	2.86
Costco Companies	1.48	1.29	1.35	1.32	1.15	1.22	42.96	18.77	39.58	36.02	7.64	8.82	7.50	3.57	4.46	7.69

Company	Continuing Operations: Diluted EPS — As Reported 2002	2001	2000	SFAS No. 123 Pro Forma 2002	2001	2000	Options Outstanding 2002	Ex. Price	2001	2000	Options Granted 2002	2001	2000	Options Exercised 2002	2001	2000
Dillard's	1.60	0.78	1.06	1.49	0.71	0.98	9.67	20.62	10.71	11.27	2.31	0.65	2.17	2.15	0.35	0.00
Dollar General	0.79	0.62	0.21	0.75	0.59	0.15	26.92	6.90	25.97	22.09	4.15	7.20	5.80	0.69	1.32	4.10
Ebay	0.85	0.32	0.17	0.21	-0.44	-0.45	37.18	26.16	35.10	26.25	16.87	19.62	9.04	9.77	6.81	4.50
Family Dollar Stores	1.25	1.10	1.00	1.22	1.08	0.98	4.41	10.02	4.39	4.17	1.48	1.34	0.92	1.29	0.90	0.53
Federated Dept Stores	3.21	2.59	3.97	3	2.35	3.77	27.70	29.71	25.61	24.08	4.40	4.00	8.25	0.82	1.51	0.42
Gap	0.54	-0.01	1.00	0.5	-0.10	0.86	80.49	6.73	109.13	97.08	14.17	30.45	28.59	19.48	9.37	13.09
Genuine Parts	2.10	1.71	2.20	2.08	1.71	2.19	7.57	29.00	6.16	7.51	3.13	0.03	2.41	1.41	1.05	0.01
Home Depot	1.56	1.29	1.10	1.46	1.19	1.01	83.17	18.27	69.45	65.80	31.66	25.33	14.87	9.91	16.61	14.69
Kohl's	1.87	1.45	1.10	1.78	1.38	1.04	18.91	14.36	21.25	21.86	0.33	2.89	2.59	2.18	2.97	5.97
Limited Brands	0.95	1.16	0.91	0.97	1.10	0.86	43.96	10.95	30.46	30.21	7.95	5.82	4.08	4.54	2.46	4.16
Lowe's Companies	1.85	1.30	1.05	1.73	1.22	1.01	20.65	22.20	19.14	15.51	5.54	10.87	7.37	2.94	5.62	1.26
May Department Stores	1.76	2.22	2.62	1.69	2.15	2.55	25.28	26.00	22.47	20.06	5.13	4.69	7.22	0.95	1.59	0.57
Nordstrom	0.66	0.93	0.78	0.52	0.80	0.68	11.89	19.00	10.76	8.87	2.42	3.29	2.47	0.35	0.19	0.18
Office Depot	0.98	0.66	0.16	0.89	0.54	0.04	31.50	14.74	35.00	36.41	6.93	6.76	9.94	3.01	5.52	0.43
Penney, J.C.	1.25	0.32	-2.29	1.18	0.29	-2.37	22.27	15.00	18.69	18.17	4.99	3.40	7.29	0.61	0.06	0.00
Radioshack	1.45	0.85	1.84	1.21	0.57	1.67	22.82	17.50	22.87	15.18	1.52	9.38	5.00	0.53	0.38	1.57
Sears	4.94	2.24	3.88	4.79	2.08	3.75	26.88	32.96	32.58	21.95	1.08	14.94	6.35	3.41	2.05	0.85
Sherwin-Williams	2.04	1.68	0.10	1.98	1.62	0.06	15.18	20.94	14.13	12.59	3.06	3.07	2.82	1.79	1.03	0.53
Staples	0.94	0.40	0.15	0.87	0.36	0.06	51.68	7.63	51.26	48.31	11.04	10.75	17.21	7.39	5.55	4.57
Target	1.81	1.51	1.38	1.78	1.48	1.37	34.79	12.22	31.32	32.26	6.10	4.81	5.62	2.06	5.31	4.94
Tiffany & Company	1.28	1.15	1.26	1.19	1.08	1.20	13.21	8.73	12.51	11.33	2.23	2.07	1.58	1.18	0.64	1.31
TJX Companies	1.08	0.97	0.93	1	0.92	0.90	37.20	10.94	29.62	28.07	11.40	10.74	10.36	2.97	8.43	5.45
Toys R Us	1.09	0.33	1.88	0.91	0.14	1.79	32.60	0.00	30.60	24.70	6.00	8.60	7.50	0.00	1.10	0.40
Wal Mart Stores	1.81	1.49	1.40	1.79	1.47	1.39	59.11	23.90	53.47	52.05	15.27	12.82	12.05	6.60	9.43	7.87
Software & Services																
Adobe Systems	0.79	0.83	1.13	0.03	0.12	0.77	57.85	15.99	54.28	45.02	11.97	19.18	19.67	3.69	4.83	8.72
Autodesk	0.28	0.80	0.80	-0.13	0.41	0.48	29.45	14.42	29.16	27.00	7.36	8.72	8.91	3.43	5.02	7.39
BMC Software	-0.75	0.17	0.96	-1.09	-0.17	0.81	42.40	9.00	37.70	28.60	12.30	16.10	9.80	1.10	2.70	7.30
Citrix Systems	0.52	0.54	0.47	-0.35	-0.22	-0.21	41.22	6.12	39.60	43.29	9.96	8.35	12.67	0.55	8.55	6.69
Computer Associates	-1.91	-1.02	1.25	-2.05	-1.18	1.12	46.90	12.40	48.50	47.60	4.50	11.10	7.10	3.20	4.50	6.90
Computer Sciences	2.01	1.37	2.37	1.91	1.15	2.25	11.54	20.34	11.83	10.70	4.11	3.35	2.85	1.07	1.23	2.44
Compuware	-0.66	0.32	0.91	-0.83	0.17	0.74	65.86	5.02	46.27	44.97	31.38	11.48	8.39	4.02	2.46	7.70
Electronic Arts	0.71	-0.08	0.88	0.2	-0.53	0.60	22.82	22.27	21.54	22.93	6.31	5.85	7.82	3.68	5.50	6.04
Electronic Data Systems	2.06	2.86	2.40	1.5	2.61	2.23	73.90	44.00	57.10	52.90	26.50	17.20	20.10	0.70	8.10	0.90
Intuit	0.32	-0.47	1.45	-0.09	-0.98	0.99	34.66	19.07	35.83	31.27	8.89	12.56	9.89	5.96	5.20	6.65
Mercury Interactive	0.74	0.20	0.70	-0.49	-1.29	0.01	22.66	10.11	19.59	17.40	6.11	5.59	8.35	1.46	2.33	2.81
Microsoft	1.41	1.38	1.70	0.96	0.97	1.48	802.00	12.82	898.00	832.00	41.00	224.00	304.00	99.00	123.00	198.00
Novell	-0.28	-0.79	0.15	-0.56	-1.16	-0.15	75.81	2.00	74.51	67.11	5.45	35.97	38.12	1.37	2.72	11.45
Oracle	0.39	0.44	1.05	0.31	0.34	0.98	454.00	4.20	441.65	592.41	65.00	13.02	257.32	29.00	109.49	100.82
Parametric Technology	-0.36	-0.03	-0.01	-0.75	-0.36	-0.33	74.49	4.41	66.17	60.62	18.46	15.17	21.41	0.13	1.58	5.80
Peoplesoft	0.57	0.59	0.48	0.01	0.21	0.19	75.97	12.95	59.93	63.72	28.94	17.33	37.31	6.75	16.71	15.24
Siebel Systems	-0.08	0.49	0.24	-2.27	-1.02	-0.29	185.48	5.97	247.20	175.78	5.89	110.84	46.76	10.66	20.60	29.50
Sungard Data Systems	1.12	0.86	0.78	0.94	0.74	0.70	40.05	12.59	34.81	29.58	8.69	10.81	14.15	1.82	4.66	4.62
Symantec Corp	-0.20	0.47	1.37	-0.75	0.06	1.16	28.78	14.56	31.73	20.04	8.45	18.33	10.36	8.25	3.54	7.87
Unisys	0.69	-0.18	0.77	0.54	-0.32	0.64	38.89	7.68	28.65	22.09	13.87	9.12	7.67	0.65	0.70	1.46
Veritas Software	0.14	-1.63	-1.55	-0.58	-2.36	-1.93	72.36	9.14	59.62	54.82	25.90	21.26	19.02	6.09	10.53	15.81

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Options Outstanding Ex. Price	Options Outstanding 2001	Options Outstanding 2000	Options Granted 2002	Options Granted 2001	Options Granted 2000	Options Exercised 2002	Options Exercised 2001	Options Exercised 2000
Yahoo!	0.18	-0.16	0.12	-0.63	-1.73	-2.30	132.48	3.87	136.96	118.33	32.57	60.26	27.18	17.41	15.32	23.80
Technology Hardware &																
ADC Telecommunications	-1.44	-1.64	1.13	-1.58	-1.77	0.99	107.60	0.87	95.90	96.50	43.00	30.60	38.70	1.20	7.50	20.00
Advanced Micro Devices	-3.81	-0.18	2.95	-4.24	-0.54	2.51	60.41	6.23	52.94	43.85	11.82	14.09	21.04	0.95	3.55	15.93
Agilent Technologies	-2.20	-0.89	1.48	-2.87	-1.99	0.86	73.84	12.00	63.66	45.89	20.15	20.76	30.20	1.13	1.11	0.65
Altera	0.23	-0.10	1.19	0.01	-0.32	1.07	60.13	6.40	56.04	50.68	12.52	12.12	13.41	5.17	3.67	7.39
Analog Devices	0.28	0.93	1.59	-0.33	0.50	1.38	85.85	6.51	63.74	52.25	28.13	17.04	15.83	3.87	3.94	7.21
Andrew Corp	0.12	0.85	1.08	0.04	0.77	1.01	5.69	12.72	4.67	3.72	1.32	1.33	1.06	0.16	0.03	0.68
Apple Computer	0.18	-0.11	2.18	-0.46	-1.19	1.38	109.43	11.99	97.18	70.76	23.24	34.86	45.66	6.25	1.83	6.87
Applied Materials	0.16	0.46	1.20	-0.03	0.33	1.11	268.56	6.82	301.27	243.99	8.80	93.03	73.22	19.16	21.28	41.70
Applied Micro Circuits	-12.08	-1.63	0.20	-12.62	-2.55	0.08	25.81	3.52	54.47	40.57	10.27	24.58	27.60	3.44	9.73	6.37
Avaya	-2.44	-1.33	-1.39	-2.54	-1.60	-1.74	44.83	3.84	48.32	55.48	10.39	31.63	27.10	0.15	1.38	7.53
Broadcom	-8.35	-10.79	-3.13	-10.77	-13.42	-5.01	132.00	5.48	106.91	79.54	40.69	51.80	25.96	4.65	5.84	10.01
Ciena Corp	-4.37	-5.75	0.27	-4.26	-6.79	-0.09	42.28	2.30	46.93	30.72	26.62	23.72	12.53	2.12	3.99	9.38
Cisco Systems	0.25	-0.14	0.30	0.05	-0.38	0.21	1206.0	6.99	1060.0	971.00	282.00	320.00	295.00	54.00	133.00	176.00
Comverse Technology	-0.69	0.29	1.39	-1.49	-0.71	0.93	25.08	7.87	33.09	26.16	15.85	9.95	9.31	0.53	1.46	6.99
Corning	-1.85	-5.93	0.41	-2.12	-6.29	0.33	97.33	1.86	72.39	45.00	26.85	29.78	23.55	0.06	1.26	17.30
Dell	0.80	0.46	0.81	0.51	0.19	0.65	387.00	7.69	350.00	344.00	84.00	126.00	154.00	22.00	63.00	95.00
EMC	-0.05	-0.23	0.79	-0.22	-0.38	0.71	177.60	4.25	151.62	104.68	52.41	84.70	31.56	4.58	24.12	25.86
Gateway	-0.95	-3.14	0.76	-1.06	-3.36	-0.13	53.44	5.99	63.81	48.64	15.10	35.14	19.31	0.04	0.57	4.09
Hewlett-Packard	-0.37	0.32	1.73	-0.68	-0.03	1.56	459.33	7.00	217.44	163.13	66.44	65.63	85.41	9.21	7.61	34.50
IBM	3.07	4.35	4.44	2.38	3.69	3.99	222.94	33.00	177.96	160.56	59.97	43.41	42.60	7.49	20.35	18.24
Intel	0.46	0.19	1.51	0.29	0.04	1.40	845.40	6.79	768.50	638.20	173.60	238.10	162.80	51.40	68.00	107.50
Jabil Circuit	0.17	0.59	0.78	0.01	0.46	0.63	12.96	6.70	9.82	12.98	4.38	3.17	2.75	0.47	6.10362	2.27
JDS Uniphase	-6.50	-51.40	-1.27	-6.92	-51.80	-1.56	152.57	3.08	171.54	141.41	46.03	46.79	60.35	11.93	41.58	35.79
KLA-Tencor	1.10	2.01	1.32	0.47	1.50	1.05	30.09	19.36	26.29	22.36	9.76	10.27	8.17	4.17	3.92	8.69
Lexmark	2.79	2.05	2.13	2.54	1.84	1.97	13.20	15.80	13.30	13.10	2.50	4.00	2.19	1.80	3.20	2.02
Linear Technology	0.60	1.29	0.88	0.4	1.10	0.75	38.89	9.69	41.80	39.89	1.84	7.84	3.81	3.52	5.16	7.54
LSI Logic	-0.79	-2.84	0.70	-1.36	-3.49	0.43	57.07	8.57	74.00	55.16	8.43	18.91	18.07	1.61	3.44	8.11
Lucent	-3.51	-4.18	0.51	-	-4.47	0.28	286.89	0.41-1.50	682.61	431.51	13.95	347.56	285.80	6.77	10.50	74.96
Maxim Integrated	0.73	0.93	1.04	0.25	0.57	0.81	94.26	10.27	89.29	83.20	17.95	23.02	14.57	9.96	12.21	18.13
Micron Technology	-1.51	-0.88	2.63	-2.14	-1.09	2.44	80.40	15.54	61.40	48.90	24.50	20.40	17.20	3.30	5.80	15.60
Molex	0.39	1.03	1.12	0.36	1.01	1.11	7.28	12.67	6.54	6.04	1.51	1.40	1.33	0.59	0.78	0.61
Motorola	-1.09	-1.78	0.58	-1.22	-1.93	0.51	286.54	9.00	217.07	154.89	100.07	82.49	69.91	8.40	5.73	18.86
National Semiconductor	-0.69	1.30	3.27	-1.58	0.70	2.90	41.50	18.15	38.50	33.00	9.80	11.50	9.40	4.50	3.00	6.60
NCR	1.27	2.22	1.82	0.82	1.82	1.43	16.38	33.25	15.52	15.92	2.42	3.60	4.49	0.52	2.48	2.33
Network Appliance	0.01	0.21	0.21	-0.79	-0.47	0.05	79.52	3.88	72.56	73.64	16.44	17.87	25.77	5.29	15.48	18.98
Novellus Systems	0.15	0.97	1.66	-0.32	0.51	1.33	26.06	15.23	22.56	17.99	6.29	7.61	5.02	2.49	2.51	3.16
Nvidia Corporation	0.54	1.03	0.62	-0.5	0.51	0.43	35.64	4.62	51.88	50.55	8.52	15.15	21.85	3.82	12.28	9.02
PerkinElmer	-0.03	-0.01	0.58	-0.2	-0.34	0.44	15.48	11.74	15.99	9.65	3.25	9.32	5.56	0.63	2.07	3.72
PMC-Sierra, Inc	-0.38	-3.80	0.41	-0.98	-4.45	0.10	11.14	2.76	32.10	24.04	0.66	14.84	3.86	0.96	3.00	4.06
QLogic	0.74	0.72	0.52	0.44	0.32	0.31	9.35	9.46	7.50	7.52	2.93	2.67	2.93	0.56	2.43	3.01
Qualcomm	0.44	-0.74	0.79	0.16	-0.96	0.66	117.27	5.68	108.18	109.97	26.53	15.59	9.52	14.33	14.83	22.02
Sanmina	-5.60	0.12	0.64	-5.73	-0.06	0.29	54.41	7.20	31.60	31.22	16.75	6.17	9.48	1.17	4.05	5.46
Scientific-Atlanta	0.66	1.99	0.94	0.22	1.52	0.58	19.24	11.41	15.57	15.29	4.55	5.33	9.29	0.27	4.72	4.69
Solectron	-3.98	-0.19	0.80	-4.1	-0.32	0.71	63.20	6.02	47.90	44.10	26.10	14.40	13.40	3.10	7.00	10.8

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Options Outstanding Ex. Price	Options Outstanding 2001	Options Outstanding 2000	Options Granted 2002	Options Granted 2001	Options Granted 2000	Options Exercised 2002	Options Exercised 2001	Options Exercised 2000
Sun Microsystems	-0.18	0.29	0.55	-0.38	0.13	0.46	556.00	2.80	500.00	458.00	119.00	124.00	132.00	28.00	63.00	70.00
Symbol Technologies	NYA	-0.24	-0.33	NYA	-0.34	-0.42	NYA	NYA	36.30	38.44	NYA	5.44	4.16	NYA	6.02	5.02
Tektronix	0.33	1.46	0.13	0.13	1.32	-0.01	9.24	14.60	5.86	5.17	3.99	2.70	3.24	0.22	1.65	4.64
Tellabs	-0.76	-0.44	1.82	-1.05	-0.74	1.67	42.33	1.35	37.93	26.20	16.78	17.89	9.21	2.14	2.27	3.19
Teradyne	-3.93	-1.15	2.86	-4.53	-1.57	2.53	33.42	15.79	29.75	22.75	7.21	10.29	7.91	1.15	2.77	3.22
Texas Instruments	-0.20	-0.12	1.73	-0.43	-0.29	1.58	190.41	7.25	164.43	145.96	37.27	35.26	30.55	7.93	10.21	20.12
Thermo Electron	1.12	0.27	0.36	0.99	0.14	0.25	22.47	13.03	19.66	24.58	5.32	3.09	2.60	2.05	4.26	5.92
Waters Corp	1.12	0.83	1.14	0.93	0.70	1.07	17.33	7.62	17.20	16.09	1.60	2.25	1.73	1.18	1.05	5.24
Xerox	0.10	-0.15	-0.48	0	-0.28	-0.65	76.85	34.00	68.63	58.23	14.29	15.09	19.34	5.67	4.48	0.07
Xilinx	-0.34	0.10	1.90	-0.68	-0.31	1.60	56.77	9.10	54.25	55.33	9.80	7.81	4.15	6.36	8.01	11.00
Telecommunication Services																
Alltel	2.96	3.34	6.20	2.86	3.26	6.14	18.32	28.03	16.25	14.86	3.15	3.28	5.71	0.61	0.95	0.97
AT&T	1.26	-0.91	11.01	0.87	-1.76	10.35	98.26	32.28	63.51	49.81	15.18	13.68	14.91	0.44	1.04	2.29
AT&T Wireless Services	-0.82	0.05	0.28	-0.95	-0.02	0.21	215.25	9.17	176.24	73.63	39.77	34.95	76.98	0.36	0.970	0.000
BellSouth	1.44	1.36	2.23	1.39	1.30	2.18	106.33	17.55	93.47	84.81	19.38	16.36	23.60	3.76	5.34	7.79
CenturyTel	1.33	1.01	0.88	1.23	0.95	0.84	6.90	13.97	6.37	4.68	1.98	1.97	1.57	1.37	0.15	0.37
Citizens Communication	-2.93	-0.28	-0.15	-2.97	-0.38	-0.24	19.13	7.90	19.06	17.62	3.07	3.97	5.78	0.81	1.73	4.13
Nextel Communications	1.78	-3.67	-1.35	1.43	-4.10	-1.71	88.20	7.12	78.80	54.40	28.60	31.90	24.10	4.80	1.50	7.00
Qwest	NYA	-2.38	-0.06	NYA	-2.54	-0.13	NYA	NYA	104.05	130.08	NYA	38.48	41.70	NYA	14.10	20.83
SBC Communications	2.23	2.07	2.27	2.15	2.00	2.22	229.00	20.80	207.00	156.00	36.00	76.00	51.00	7.00	13.00	30.00
Sprint Corp Fon Group	1.18	-0.33	1.28	1.08	-0.49	0.95	98.80	11.76	80.20	44.80	24.20	43.80	24.30	0.20	0.80	11.50
Sprint Corp Pcs Group	-0.58	-1.27	-1.95	-0.7	-1.48	-2.22	72.80	5.83	56.10	26.90	22.80	35.30	19.10	0.30	2.70	16.20
Verizon Communications	1.67	0.22	3.95	1.50	0.12	3.83	261.44	28.15	245.21	232.57	31.21	34.22	98.02	7.42	15.36	14.66
Transportation																
Burlington North Santa Fe	2.00	1.89	2.36	1.95	1.86	2.25	39.32	21.58	39.84	38.42	2.87	7.42	11.52	2.34	5.28	1.26
CSX	2.19	1.38	0.88	2.07	1.32	0.79	26.02	31.45	23.31	20.13	3.44	5.04	2.74	1.02	0.78	0.46
Delta Air Lines	-10.44	-9.99	7.05	-10.82	-10.23	6.85	58.81	27.00	51.54	50.37	8.48	2.36	3.91	0.01	0.08	0.73
FedEx	2.39	1.99	2.32	2.27	1.89	2.23	17.31	22.34	17.50	15.01	4.02	4.27	3.22	3.88	1.47	1.23
Norfolk Southern	1.18	0.94	0.45	1.1	0.90	0.39	37.66	17.48	33.41	28.12	7.38	6.99	7.71	2.85	1.08	0.27
Ryder	1.80	0.31	1.49	1.68	0.18	1.37	8.62	21.92	8.91	8.77	1.29	0.85	2.97	1.34	0.23	0.07
Southwest Airlines	0.30	0.63	0.79	0.23	0.61	0.76	138.17	5.08	95.40	99.76	52.84	5.69	16.61	8.02	8.30	15.31
Union Pacific	5.05	3.77	3.34	4.98	3.69	3.23	21.35	45.99	23.19	25.34	2.11	1.80	0.25	3.81	2.04	0.18
United Parcel Service	2.87	2.12	2.50	2.81	2.07	2.47	27.75	15.91	29.22	29.31	5.76	5.52	0.19	6.43	5.92	7.28
Utilities																
AES Corp.	-4.81	0.87	1.65	-5.08	0.79	1.57	33.24	5.10	33.49	15.58	1.14	21.16	2.08	0.23	1.51	5.07
Allegheny Energy		3.73	2.84		3.70	2.83			2.14	1.77		0.43	0.65		0.00	0.00
Ameren	2.60	3.45	3.33	2.6	3.45	3.33	1.98	36.11	2.24	2.44	0.00	0.00	0.96	0.26	0.11	0.30
American Electric Power	0.06	2.85	0.56	0.03	2.81	0.55	8.79	36.00	6.82	6.61	2.92	0.65	6.05	0.60	0.22	0.03
Calpine	0.14	1.70	1.07	0.04	1.59		30.10	0.77	27.69	30.63	9.00	3.01	4.38	5.11	5.46	4.53
Center Point Energy	1.29	1.53	0.77	1.26	1.49	0.74	12.46	20.59	9.83	10.04	3.12	1.89	5.94	0.07	1.81	1.06
Cinergy	2.34	2.75	2.50	2.35	2.72	2.47	7.58	23.99	7.73	7.27	1.24	1.11	1.33	1.31	0.50	0.13
CMS Energy	-2.99	-1.79	-0.35	-2.99	-1.79	-0.35	5.12	17.07	3.91	3.06	1.49	1.04	0.88	0.04	0.15	0.19
Consolidated Edison	3.13	3.21	2.74	3.1	3.19	2.72	6.80	30.81	5.75	4.79	1.58	1.48705	1.3495	0.41	0.36	0.07
Constellation Energy Group	3.20	0.52	2.30	3.13	0.50	2.30	6.08	0.00	2.65	2.42	3.75	1.02	2.46	0.00	0.51	NA

S&P 500 Companies Options Information

Company	Continuing Operations: Diluted EPS — As Reported 2002	As Reported 2001	As Reported 2000	SFAS No. 123 Pro Forma 2002	SFAS No. 123 Pro Forma 2001	SFAS No. 123 Pro Forma 2000	Options Outstanding 2002	Options Outstanding Ex. Price	Options Outstanding 2001	Options Outstanding 2000	Options Granted 2002	Options Granted 2001	Options Granted 2000	Options Exercised 2002	Options Exercised 2001	Options Exercised 2000
Dominion Resources	4.82	2.15	1.76	4.65	2.06	-1.73	21.06	44.54	20.99	10.33	3.12	12.15	5.39	3.06	1.48	2.20
DTE Energy	3.83	2.14	3.27	3.79	2.08	3.25	5.48	34.64	5.28	2.98	1.33	2.78	2.02	0.68	0.40	0.01
Duke Energy	1.22	2.56	2.38	1.15	2.53	2.36	31.21	23.00	26.41	22.51	9.41	7.09	7.59	1.45	2.29	2.05
Dynegy	-6.24	1.06	1.26	-6.42	0.89	1.21	28.08	2.95	33.92	21.26	2.28	15.82	1.96	3.01	2.543	8.329
Edison Int'l	3.46	7.36	-5.84	3.47	7.35	-5.87	11.84	12.45	9.29	19.77	3.45	1.00	13.37	0.07	0.00	0.52
El Paso Energy	-2.30	0.13	2.43	-2.56	-0.17	2.36	43.21	22.44	44.82	19.66	3.44	28.33	1.07	0.31	1.40	3.65
Entergy	2.64	3.13	2.97	2.46	2.94	2.89	19.94	28.62	17.32	11.47	8.17	8.60	7.22	4.88	2.41	0.92
Exelon	5.15	4.39	2.77	5.05	4.37	2.48	15.89	33.37	14.04	15.29	3.94	0.63	5.79	1.82	1.70	1.73
FirstEnergy	2.33	2.84	2.69	2.3	2.82	2.69	10.44	23.56	8.45	5.02	3.40	4.24	3.01	1.02	0.69	0.09
FPL Group	4.01	4.62	4.14	3.97	4.59	4.09	3.65	41.19	2.14	0.39	1.67	2.01	0.56	0.07	0.12	1.06
Keyspan	2.75	1.71	2.11	2.7	1.65	2.06	9.52	24.42	7.80	6.46	2.80	2.29	3.17	0.51	0.81	1.58
Kinder Morgan	2.50	1.97	1.60	2.38	1.84	1.54	7.48	23.46	6.98	6.09	1.23	2.14	1.36	0.52	0.90	0.54
Mirant	-5.85	1.34	1.03	-5.91	1.26	0.99	20.63	3.35	15.29	8.56	7.84	8.46	8.63	0.04	1.09	0.00
Nicor	2.88	2.69	0.77	2.87	2.68	0.76	0.88	30.25	0.86	0.90	0.18	0.17	0.25	0.14	0.21	0.03
NiSource	2.00	1.08	1.04	1.97	1.05	1.02	6.96	15.47	5.51	4.46	2.19	1.73	1.24	0.31	0.56	0.60
Peoples Energy	2.51	2.74	2.44	2.46	2.72	2.38	0.96	33.47	0.46	0.49	0.55	0.29	0.21	0.04	0.31	0.01
PG&E Corp	-0.15	2.99	-9.18	-0.2	2.93	-9.21	31.10	23.65	34.10	24.30	0.20	11.40	10.20	0.30	0.10	1.20
Pinnacle West Capital	2.53	3.85	3.56	2.51	3.82	3.55	2.19	28.25	1.83	1.57	0.60	0.44	0.45	0.16	0.16	0.28
PPL	1.36	1.15	3.37	1.33	1.12	3.37	3.01	22.82	2.26	1.97	0.84	0.92	1.50	0.06	0.55	0.06
Progress Energy	2.53	2.64	3.03	2.49	2.63	3.03	5.16	NA	2.33	NA	2.89	2.40	NA	NA	NA	NA
Public Service Ent	1.99	3.67	3.55	1.94	3.62	3.53	9.19	36.28	7.65	5.19	1.89	2.83	2.75	0.16	0.30	0.11
Sempra Energy	2.79	2.52	2.06	2.75	2.52	2.06	16.09	18.64	13.19	11.59	3.44	2.93	4.34	0.40	1.01	0.73
Southern Co.	1.85	1.61	1.52	1.82	1.59	1.51	32.68	15.16	29.63	22.57	8.04	13.62	11.04	4.89	3.16	1.56
Teco Energy	1.95	2.24	1.97	1.91	2.20	1.95	6.62	20.93	5.39	4.82	1.80	1.30	1.29	0.51	0.70	0.52
TXU	0.55	2.38	2.48	0.55	2.38	2.48	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Williams Companies	-1.14	1.61	1.83	-1.17	1.59	1.51	38.80	11.77	25.60	23.10	15.80	4.80	3.80	0.50	3.30	3.30
Xcel Energy	-4.36	2.27	1.60	-4.38	2.26	1.58	16.98	20.27	15.21	14.26	0.00	2.58	6.98	0.11	1.47	0.45

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	2001	2000	Expected Life 2002	2001	2000	Interest Rate 2002	2001	2000	Dividend 2002	2001	2000
Automobiles & Components															
Cooper Tire & Rubber	3.35	3.52	3.93	33.0%	26.9%	24.5%	4.3	5.5	5.6	3.0%	4.9%	6.8%	2.8%	2.3%	1.6%
Dana	7.67	7.49	6.51	53.2%	44.7%	40.7%	5.4	5.4	5.4	3.5%	4.6%	6.2%	0.3%	5.0%	5.4%
Delphi	4.31	4.13	5.88	37.9%	39.7%	36.6%	5	5	5	3.9%	4.4%	5.1%	2.3%	2.0%	1.8%
Ford	5.76	8.88	6.27	35.0%	43.9%	38.8%	7	6	5	5.1%	5.1%	6.3%	2.5%	4.0%	4.9%
General Motors	NA	NA	NA	34.6%	31.1%-31.2%	27.6-27.8%	5	5	5	4.3%	4.6%	6.4-6.5%	4.0%	3.8%	2.7%
Goodyear Tire	3.59	6.95	6.58	47.5%	25.2%	30.5%	5	5	5	3.2%	4.5%	5.4%	0.0%	3.2%	2.8%
Harley-Davidson	19.27	16.67	13.72	40.0%	40.0%	40.0%	4.4	4.4	4.4	4.0%	5.0%	7.0%	0.3%	0.2%	0.3%
Johnson Controls	19.00	14.00	15.00	22.9%	21.4%	19.9%	6	5	6	4.0%	5.7%	6.2%	1.8%	1.9%	2.1%
Visteon	6.27	6.83-7.94	NA	51.6%	42.8%	NA	6	4.7	NA	4.8%	4.7%	NA	1.8%	1.4%	NA
Banks															
Amsouth Bancorporation	4.93	3.79	3.21	31.4%	31.5%	23.8%	7	7	7	4.9%	5.0%	6.8%	4.4%	5.0%	5.0%
Bank Of America	12.41	10.36	11.00	26.86-31.02%	26.68-31.62%	25.59-30.27%	4-7	4-7	4-7	4.14-5.00%	4.89%-5.05%	6.57-6.74%	4.37-4.76%	4.50-5.13%	4.6%
Bank Of New York	10.49	12.40	10.93	30.00%	28.0%	29.0%	5	5	5	4.4%	4.8%	6.7%	2.5%	3.0%	3.0%
Bank One	12.68	13.34	9.80	35.84%	19.11%-42.29%	19.11-42.29%	4.88	2-13	2-13	4.3%	4.85%-6.43%	4.36-6.43%	2.0%	2.29%-4.86%	2.61-4.86%
BB&T	9.07	10.00	7.78	27.00%	28.0%	29.0%	6	6	6.1	4.7%	4.9%	6.6%	3.0%	2.5%	2.5%
Charter One Financial	8.90	10.68	8.45	35.94-38.13%	34.40-43.66%	43.00-45.41%	6	7	7	3.41-4.98%	4.42-5.55%	5.20-6.78%	3.0%	2.0%	2.0%
Comerica	17.64	14.02	11.18	33.00%	31.0%	28.0%	4.8	4.8	4.8	4.7%	4.9%	6.5%	2.7%	2.7%	2.8%
Fifth Third Bancorp	26.14	18.79	14.81	28.00%	28.0%	27.0%	9	9	9	5.0%	5.1%	5.2%	1.4%	1.8%	1.0%
First Tennessee National	8.25-13.47	8.18-8.58	5.20-5.34	30.30%	24.6%	24.3%	4.44-4.54	2.19-6.19	2.08-6.56	4.1%	4.8%	5.5%	2.8%	2.7%	2.8%
FleetBoston Financial	4.23	8.71	9.30	37.00%	35.0%	33.0%	4	5	5	3.0%	4.0%	6.0%	6.4%	3.8%	3.1%
Golden West Financial	17.27	14.14	8.88	26.00%	26.0%	25.0%	5.3	5.3	5.3	2.7%	4.3%	5.0%	0.5%	0.8%	1.1%
Huntington Bancshares	5.18	4.55	5.58	33.80%	41.0%	45.1%	NA	6	6	4.1%	5.1%	6.1%	3.3%	5.0%	4.4%
KeyCorp	3.95	6.26	3.49	26.40%	33.0%	26.7%	4.1	3.9	4.7	3.9%	5.0%	6.6%	4.8%	4.2%	5.8%
Marshall & Ilsley Corp	8.15	10.09	6.91	30.95-31.25%	31.1%-0.31%	24.36%-31.33%	6	6	6	3.11-5.16%	3.92%-5.30%	5.14%-6.79%	2.1%	2.1%	2.1%
Mellon Financial Corp	6.82-11.11	10.64-12.03	9.01-11.93	33.00%	26-33%	25-31%	5.7	3.5-4.2	3.5-3.9	3.4%	3.7-6.2%	4.4-6.2%	1.7%	1.3-2.4%	1.8-2.6%
National City Corp	5.09	5.83	3.11	26.10%	23.6%	22.1%	5	4	4	3.5%	5.6%	5.0%	3.9%	3.5%	3.5%
North Fork	8.15	7.92	5.49	27.71%	27.1-27.7%	25.6-27.3%	6.00	6	6	3.9%	3.9-5.1%	5.15-6.25%	3.11%	2.7-3.43%	2.9%
Northern Trust	18.75	24.30	25.92	31.20%	30.0%	30.0%	6.2	5.9	5.4	5.1%	5.4%	6.4%	1.3%	1.0%	0.9%
PNC Fin'l Services	11.40	15.87	9.86	26.70%	25.7%	21.8%	5	5	5	4.4%	4.9%	6.6%	3.5%	3.2%	3.1%
Regions Fin'l Corp	4.61	4.83	3.52	21.80%	22.2%	22.2%	5	5	5	2.7%	4.3%	5.0%	3.5%	3.7%	3.9%
Southtrust	6.35	5.37	4.18	28.00%	34.0%	32.0%	7	4.00	4.00	4.8%	5.0%	6.5%	3.2%	2.8%	3.2%
Suntrust Banks	9.71	7.96	7.51	14.68%	10.1%	10.5%	6	6	5	4.1%	4.4%	5.8%	2.7%	2.5%	2.9%
Synovus Financial	8.37	8.56	6.42	34.00%	31.0%	36.0%	6.6	7.9	6.3	5.0%	4.6%	6.4%	2.4%	1.8%	2.3%
U.S. Bancorp	7.03	6.76	6.32	41.00%	42.0%	37.0%	6	4.5	4.7	3.3%	4.6%	6.1%	3.0%	3.0%	3.0%
Union Planters	NA	NA	NA	29.62%	29.8%	30.9%	3.9	5.1	4.4	2.6%	3.7%	5.3%	5.1%	5.2%	5.9%
Wachovia Corp	10.39	5.21	8.76	29.00%	29.0%	45.0%	6	4	4	4.7%	4.22-4.45%	5.71-6.73%	2.5%	3.0%	6.1%
Washington Mutual	NA	9.66	10.18	30.92-35.30%	31.03-35.66%	30.46-34.26%	2.75-7.5	5-7	5-7.25	2.25-5.15%	3.50-4.91	5.11-6.71%	2.71-3.00%	2.33-2.58%	2.37-2.57%
Wells Fargo & Co	12.34-15.62	5.90-14.16	4.60-10.13	29%-42%	20-42%	20-42%	1-6	1-6.6	1-6.6	2.5%-6.6%	2.2-7.8%	4.4-7.8%	2.3%-2.6%	1.4-3.4%	1.4-3.4%
Zions Bancorp	11.54	14.89	13.09	26.50%	26.6-39.4%	26.6-39.4	3.8	2-7.5	2-7.5	3.8%	3.1-6.8%	4.1-6.8	1.8%	1.5%	1.5%
Capital Goods															
3M	33.51	16.56-29.41	13.65-22.45	25.00%	24.1%	22.3%	5.5	5.58	5.67	4.6%	4.8%	6.7%	3.20%gr	4.60%gr	4.30%gr
American Power Conv	7.07	10.32	11.43	74.00%	83.0%	70.0%	6	6	6	3.2%	4.7%	5.9%	0.0%	0.0%	0.0%
American Standard	18.24	19.76	16.03	29.00%	30.0%	31.0%	5	5	6	2.5%	4.4%	5.1%	0.0%	0.0%	0.0%
Boeing	16.78	21.35	18.18	30.00%	23.0%	22-23%	9	9	9	4.5%	5.1%	5.8-6.1%	1.1%	1.1%	1.1%

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	2001	2000	Expected Life 2002	2001	2000	Interest Rate 2002	2001	2000	Dividend 2002	2001	2000
Caterpillar	14 85	14 56	10 92	35 00%	30 1%	26 4%	5	5	5	4 1%	4 9%	6 2%	2 6%	2 5%	2 1%
Cooper Industries	NA	NA	NA	33 00%	27 5%	26 4%	7	7	7	4 8%	5 1%	6 7%	3.9%	3 5%	3 5%
Crane	6 42	7 64	5 91	27 97%	27 0%	26 5%	5 23	5 11	5 11	4 7%	4 9%	6 6%	1 7%	1 5%	2 0%
Cummins	NYA	13.46	12 58	NYA	47 0%	41 0%	NYA	10	10	NYA	5 8%	6.5%	NYA	NA	NA
Danaher	28 00	48 00	32 00	33 79%	36 0%	37 6%	8	10	10	3 3%	5 1%	6 0%	CURR AR	CURR AR	CURR AR
Deere	48 43	12 06	12 06	36.00%	33 2%	30 4%	3 7	4 1	4.5	3 6%	5 4%	6 2%	2 1%	2 1%	2 1%
Dover	15 29	16 59	16 38	28 10%	28 3%	23 7%	9	9	9	5 3%	5 1%	6 9%	1 3%	1 2%	1 2%
Eaton	18 34	15 71	15 47	29 00%	26 0%	23 0%	4	4	4-5	2 6-4 3%	3 7-5%	6-6.8%	2 5%	2.5%	3.0%
Emerson Electric	11 03	12 03	11 75	25 00%	25 0%	22 0%	5	5	5	4 2%	5 7%	6 5%	2 9%	2 3%	2 3%
Fluor	12 00	20 00	18 00	45 50%	48 3%	39 8%	6	6	6	3.3%	4.7%	6.0%	2 2%	1 8%	1 7%
General Dynamics	21 31	17 67	10 20	26 6-32 9%	17 8-30 8%	17 6-46 1%	2 25-4 66	2 5-4 5	2-4 58	3-6 7%	4 7-6 7%	4 7-6 7%	1 3-1 8%	1 3-1 8%	1 5-1 9%
General Electric	7 73	12 15	15.76	33 70%	30 5%	27 1%	6	6	6 4	3 5%	4 9%	6 4%	2 7%	1 6%	1 2%
Goodrich	9 50	13 78	8 65	47 40%	44 2%	37 5%	7	7	7	3 7%	5 0%	5 0%	3 6%	3 5%	3 4%
Grainger W W	14.77	10.89	13 65	20 10%	20.1%	20 1%	7	7	7	4.9%	5 1%	6 4%	1 8%	1.8%	1 8%
Honeywell	12 64	13 71	18 21	43 80%	40 9%	27 8%	5	5	5	4 2%	5 2%	6 4%	1 9%	1 5%	1 4%
Illinois Tool Works	20 47	21.18	19 03	28 40%	29 9%	28 4%	5 7	5 7	5.7	4 1%	5 2%	5 4%	1.1%	1 0%	1.0%
Ingersoll-Rand	15 15	14 60	16 89	38 85%	37 6%	34 3%	5	5	4	4 7%	5 0%	6 5%	1 6%	1 7%	1 3%
ITT Industries	15 77	11 04	10 78	28 30%	27 6%	26 8%	6	6	6	4.8%	4 9%	6 7%	1.7%	1 9%	2 0%
Lockheed Martin	16 23	13 32	7 62	37 60%	36 6%	34 2%	5	5	5	4 2%	5 0%	6 6%	1 0%	0 6%	0 8%
Masco	6 66	7.94	7.16	37 00%	36 0%	28 0%	6	6	7	3 8%	5 2%	6 7%	2.7%	2 1%	1.9%
McDermott Int'l	8 23	7 26	4 61	51 00%	51 0%	48 0%	6 1	5	5	4 7%	4 8%	6 4%	0 0%	0 0%	0 0%
Navistar Int'l	14 03	7 78	14 50	39 10%	39 1%	36 9%	4	4	4	4 1%	5 4%	6.1%	0.0%	0.0%	0 0%
Northrop Grumman	39 00	26 00	25 00	35 00%	33 0%	32 0%	6	6	6	3 5%	4 7%	6 6%	1 4%	2 0%	2 2%
Paccar	13 97	12 12	11 21	48 00%	50 0%	51.0%	5	5	5	4 5%	5 5%	6 9%	4 4%	4 4%	4 5%
Pall	8 36	6 75	7 00	33 00%	33 0%	35 0%	10	10	5	5 1%	4 8%	6 6%	2 0%	3 6%	3 2%
Parker Hannifin	14 94	12.44	14.62	36 60%	36 2%	33.8%	4 80	4 6	4 6	4 6%	6 1%	6 1%	1.60%	1 6%	1.7%
Power-One	5 50	5 59	18 54	94 70%	111 9%	87 6%	5 8	6 5	7 5	4 2%	4 9%	6 2%	0 0%	0 0%	0 0%
Raytheon	13 46	9 75	5.91	40.00%	40 0%	40 0%	4	4	4	2 5-4.7%	3 7-5%	5 3-6 6%	0 0%	1 0%gr	1 0%gr
Rockwell Automation	2 99	8 79	16 30	30 00%	33 0%	33 0%	5	5	5	4 0%	5 8%	6 1%	3 8%	2 3%	2 3%
Rockwell Collins	6 69	7.27	NA	40 00%	35 0%	NA	6	5	NA	3.6%	5 3%	NA	1 7%	1 8%	NA
Textron	10 00	11 00	10 00	36 00%	34 0%	27 0%	3 7	3 5	3 5	4 0%	4 0%	5 0%	3 0%	3 0%	3 0%
Thomas & Betts	7.20	7.89	6 68	35.00%	35 0%	33 0%	5	5	5	4.3%	4 5%	6 5%	0 0%	0 0%	4 0%
Tyco	14 31	19 72	16 26	52 00%	39 0%	36 0%	5	4 4	4 5	4 3%	5 2%	6 4%	$0 05	$0 05	$0 05
United Technologies	23 20	24 83	21 33	39 00%	36 0%	30 0%	5	5	5	4 4%	4 6%	6 1%	1 6%	1 3%	1.0%
Commercial Svcs & Supplies															
Allied Waste Industries	5 55	7.43	NA	66-69%	55-61%	52-55%	4-6	5	5	2.2-4.6%	4 8-5 2%	5 3-6 9%	0.0%	0 0%	0 0%
Apollo Group	NA	NA	NA	42 00%	61 0%	74 0%	2 8	3 1	5	3 7%	5 3%	6 5%	0 0%	0 0%	0 0%
Automatic Data	16 54	21.31	16 89	25 9-27.9%	27 9-28 2	22 0-26 7%	6 3	6 3	6.4	4 3-5 2%	5 3-6	6 0-6 7%	7- 8%	.7- 8%	0 8-0 9%
Avery Dennison	16 94	18 31	22 16	29 06%	33 4%	34 6%	7	10	10	4 4%	5 1%	6 1%	2 1%	2 3%	1 4%
Block, H&R	6 77	9 34	9 09	28 61%	61.2%	30 7%	3	3	3	4 5%	6 3%	5 8%	1.8%	3 4%	2 2%
Cendant	8 43	5 27	9 99	50 00%	50 0%	55 0%	4 5	4 5	4 7	4 2%	4 4%	5 0%	0 0%	0 0%	0 0%
Cintas	22 65	21 40	21 29	34.00%	34 0%	32 0%	9	9	9	4 8%	5 5%	6 3%	0 5%	0 5%	0 5%
Concord EFS	12 53	6 64	4 14	48 20%	38 1%	51 2%	4 4	3	3	4 3%	4 8%	5 0%	0 0%	0 0%	0 0%
Convergys	13.73	16.03	22.30	42 50%	39.7%	54.5%	4	4	4.0	4.5%	4 7%	6.4%	0.0%	0 0%	0 0%
Deluxe	7 42	2 82	3 57	26 20%	25 8%	24 4%	6	6 8	9	4 8%	5 1%	6 6%	6 0%	6 9%	7 1%

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	2001	2000	Expected Life 2002	2001	2000	Interest Rate 2002	2001	2000	Dividend 2002	2001	2000
Donnelley R R	7 44	7 05	7 17	26 14%	27 0%	35 7%	10	10	10	4 6%	5 0%	6 4%	3 7%	3 4%	3 9%
Equifax	7.51	8 80	6 14	40 80%	41 0%	42 0%	2.9	2 6	2 3	3 5%	4 2%	6 5%	0 3%	0 5%	1.7%
First Data	17 00	12 00	9 00	40 00%	37 2%	35 3%	5	5	5	4 2%	4 4%	5 0%	0 2%	0 1%	0 2%
FiServe	20 24	18.02	10.72	50 00%	49 8%	46 6%	5	5	5	4.4%	4 6%	5 0%	0 0%	0 0%	0 0%
Paychex	11 78	15 55	7 62	35 00%	33 0%	30 0%	4 7	5	5	4 2%	5 7%	5 7%	1 2%	0 8%	1 1%
Pitney Bowes	9 00	9.00	9 00	30.00%	29 0%	27 0%	5	5	5	4 0%	4 0%	6 0%	3 1%	3 0%	2 9%
Robert Half	NA	NA	NA	48-60%	49-56%	49-56%	1 5-5 8	1 5-5 7	1 5-5 7	2 3-6 8%	3 5-6 8%	3 5-6 8%	0 0%	0 0%	0 0%
Sabre Holdings	17 68	17 30	13 42	53 00%	42 0%	40 0%	4 5	4 5	4 5	2 51%-4 85%	3 44-5 58%	5 65-6 51%	0 0%	0 0%	0 0%
TMP Worldwide	15 09	28 31	44 57	73 50%	75 0%	80 0%	7 5	7 5	8	4 2%	4 5%	6 3%	0 0%	0 0%	0 0%
Waste Management	12 16	10.83	6 78	23 7-50.4%	23 7%-50.4%	23 74 50 04%	4-7	4-7	3-7	2 91-6 19%	3.42%-6 19%	4 63-7 67%	0.0%	0 0%	0-2%
Consumer Durables & Apparel															
American Greetings	NA	NA	NA	58 0%	46 0%	41 0%	7 6	7 7	5 7	4 5%	5.9%	5 4%	3 9%	5 4%	3 2%
Black & Decker	18 17	11 96	16 50	33 00%	32 4%	32 2%	6 3	6 2	5 9	4 9%	4 7%	6 5%	0 99%	1 4%	1 1%
Brunswick	8 33	5.46	5.85	37.40%	33 1%	32 7%	5	5	5	4 2%	4 2%	6 1%	2.0%	2 8%	2 5%
Centex	21 32	13 14	14 80	47 00%	43 5%	35 0%	7	8	8	5 4%	6 3%	5 5%	0 4%	0 7%	0 5%
Eastman Kodak	5 99	8 37	16 79	34 00%	34 0%	29 0%	7	6	7	3 8%	4 2%	6 2%	5 8%	4 4%	3 2%
Fortune Brands	11 63	8 91	6 15	30 60%	36 4%	30 0%	4 5	4 5	4 5	2 7%	4 0%	6 0%	2 3%	3 0%	3 4%
Hasbro	7.34	5 56	6 43	43 00%	49 0%	41 0%	6	6	6	4 6%	5 0%	6 8%	0 7%	1 0%	1 6%
Jones Apparel Group	$14 72-32 71	$8 81-32 22	11 10	50 00%	49 7%	46 8%	3 5	3 6	3 8	4 0%	3 2%	5 8%	0 0%	0 0%	0 0%
KB Home	14 54	9 09	7 70	50 86%	48 9%	44 8%	4	4	4	2 9%	3 7%	5 4%	0 67%	0 9%	1 0%
Leggett & Platt	4 92-11 53	4 20-11 70	4 48-8 05	28 70%	29 2%	25 6%	5 9	5 8	7 4	3 9%	4 9%	5 7%	3 4%	3 4%	4 0%
Liz Claiborne	9 50	9 49	7 21	39 00%	46 0%	40 0%	5	5	5	2 7%	4 4%	5 0%	0 8%	0.9%	1 1%
Mattel	6 17	3 18-3 52	2 96-3 18	30 09%	16 8%	19 55-45 63%	6 16	5 5	5 67-10 0	2 9%	4 4%	5 03-6 01%	1 1%	0 9%	0 83-3 40%
Maytag	7.64	7 60	9 99	35.00%	30 0%	30 0%	5	5	5	3 6%	4 1%	5 9%	2 6%	2 3%	2 1%
Newell Rubbermaid	9 00	7 00	9 00	32 00%	28 0%	28 0%	6 9	9	9	4 0%	5 1%	6 5%	3 0%	3 0%	3 0%
Nike	16 02	17.27	15 81	38 00%	39 0%	37 0%	5	5	5	4 8%	5,4%	5.8%-6.6%	1 0%	1,0%	1.0%
Pulte Homes Inc	19 36	23 26	15 20	34 90%	34 8%	34 5%	6 82	6 97	7 33	3 5%	4 9%	5 5%	0 3%	0 4%	0 6%
Reebok	11 30	11.08	6 63	52.00%	57.0%	59 0%	3 5	3 5	3 5	2%-7 7%	3 6-7.7%	3 6-7 7%	0 0%	0 0%	0 0%
Snap-On	9 16	9 37	7 55	33 10%	38 7%	28 2%	6 1	5 6	5 6	3 8%	4 9%	6 7%	2 8%	2 8%	2 5%
Stanley Works	7 30	14.31	8 15	30.00%	40 0%	40 0%	5	7	7	3 2%	4 8%	6 1%	3 2%	2.6%	3 8%
Tupperware	3 78	6 26	NA	27 50%	40 0%	40 0%	8	5	5	3 5%	4 2%	5 9%	3 5%	3 5%	3 5%
VF Corp.	10 51	10.78	7 66	36.00%	37.0%	36.0%	4	4	4	4 0%	4.9%	6.8%	2.7%	2 0%	2 0%
Whirlpool	18 28	15 59	12 23	33 80%	32 6%	28 6%	5	5	5	2 7%	4 3%	5 1%	2 2%	2 3%	2 7%
Diversified Financials															
American Express	11 68	14 69	14 92	33 00%	31 0%	29 0%	4 5	5	5	4 3%	4 9%	6 7%	0 9%	0 8%	1 1%
Bear Stearns	21 19	19.29	14 18	33 00%	33.0%	37 0%	10	10	10	4.2%	5 2%	6.4%	1.1%	1.0%	1.5%
Capital One Financial	16 53	29 73	23 41	55 00%	50 0%	49 0%	5	8 5	4 5	3 2%	4 2%	6 1%	0 3%	0 2%	0 2%
Charles Schwab	5.35	7.26	15 44	51 00%	50 0%	46 0%	5	5	5	3 5%	4 3%	6 0%	0 3%	0 3%	0 4%
Citigroup	9 47	10 90	9 27	37 19%	38 8%	41 4%	2-3 5	3	3	3 9%	4 6%	6 2%	$0 92	$0 92	$0 76
Countrywide Financial	12 30	13 01	10.69	33 00%	29.0%	38 0%	4 16	5	5	3 8%	4 9%	6 4%	1 0%	0 7%	1.6%
Fannie Mae	22 76	19 22	16 90	31-33%	34-37%	29 0-34 0%	6	1-10	1-10	3 235-4 995%	3 62-4 99%	4 97-6 81%	$1 32	$1 20	$1 12
Federal Homeloan Mtg.	NYA	25.54	16 24	NYA	40.4%	36.2%	NYA	10	10	NYA	5 2%	6.3%	NYA	0 0%	0,0%
Federated Investors Inc	10 29	13 07	10 51-11 65	28 40%	29 9%	30 6%	6 7	8 3	10 1	4 2%	5 3%	6 4%	0 7%	0 5%	0 7%
Franklin Resources	16.14	19 58	15 31	42.00%	40 0%	38 0%	3-6	2-9	2-7	4 0%	5 0%	6 0%	1 0%	1.0%	1.0%
Goldman Sachs Group	27 38	30 82	28 13	35 00%	35 0%	35 0%	5 00	7	7	3 5%	5 2%	5 6%	0 60%	0 5%	0 6%

S&P 500 Companies Options Information

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	2001	2000	Expected Life 2002	2001	2000	Interest Rate 2002	2001	2000	Dividend 2002	2001	2000
J.P. Morgan Chase	9.49-11.57	14.60-18.39	17.66-18.79	39.00%	37.0%	38.0%	3.8-6.8	3.8-6.8	5.5-6.8	4.6%	5.1%	6.7%	3.7%	2.5%	2.3%
Janus Capital Group	12.66	13.94	17.49	59-64%	40%-69%	48.0%	2-7	3	3	1.68-4.80%	1.79%-5.27%	5.97-6.18%	.16-.32%	.09%-.19%	.09-.12%
Lehman Bros	19.07	13.54	9.91	35.00%	30.0%	35.0%	5.3	4.5	3.6	3.3%	4.2%	6.3%	$0.36	$0.28	$0.22
MBNA	8.37	7.51	5.47	34.21%	34.0%	34.9%	5.4	5.4	5.4	4.5%	4.6%	6.7%	1.1%	1.1%	1.1%
Merrill Lynch & Co	22.44	31.80	18.05	45.88%	42.8%	40.6%	5	5	5	4.6%	5.1%	6.7%	1.2%	0.8%	1.2%
Moody's	10.97	9.38	8.20	25.00%	25.0%	25.0%	4.5	4.5	4.5	4.1%	4.3%	5.9%	0.4%	0.6%	0.7%
Morgan Stanley	19.42	26.43	30.48	50.70%	48.4%	43.4%	6.2	6.1	5.3	3.8%	4.7%	5.6%	1.9%	1.5%	1.1%
Principal Financial Group	10.19	6.07	NA	32.50%	37.5%	NA	6.00	3	NA	4.7%	3.7%	NA	0.91%	1.1%	NA
Providian	4.20	19.58	24.22	93.00%	65.0%	70.0%	4	4	4.5	3.3%	4.5%	6.6%	0.0%	0.4%	0.4%
SLM Corporation	21.10-22.06	28.83-31.27	18.97-20.50	31.00%	35.0%	34.0%	3	10	10	4.0%	5.0%	6.0%	(Growth) 1.0%	(Growth) 1.0%	(Growth) 2.0%
State Street	NA	NA	NA	30.00%	30.0%	30.0%	5.2	4.1	4.1	3.1%	4.0%	5.8%	1.5%	1.1%	0.7%
T. Rowe Price	9.42	9.15	13.45	36.00%	37.0%	35.0%	5.7	5.5	4.8	4.0%	4.2%	5.6%	1.4%	1.3%	1.3%
Energy															
Amerada Hess	19.63	16.20	20.04	26.20%	24.4%	22.5%	7	7	7	4.2%	4.1%	5.4%	1.8%	2.0%	1.0%
Anadarko Petroleum	18.86	22.71	19.09	41.66%	43.8%	39.2%	5.29	4.14	4.35	3.7%	4.5%	6.1%	0.5%	0.5%	0.5%
Apache	20.28	20.58	18.05	37.17%	41.4%	37.4%	4.5	5	5	4.9%	5.0%	6.7%	0.7%	0.5%	0.6%
Ashland	5.35	7.38	7.26	26.70%	24.4%	22.9%	5	5	5	2.9%	4.1%	6.1%	3.8%	3.0%	3.3%
Baker Hughes	10.24	15.34	11.15	45.00%	53.0%	59.6%	3.8	3.1	3.2	3.5%	3.4%	5.0%	1.4%	1.1%	1.7%
BJ Services	9.98	16.82	10.20	46.20%	63.0%	64.2%	5	4.8	5	3.8%	3.6%	5.8%	0.0%	0.0%	0.0%
Burlington Resources	10.83	11.33	10.33	31.00%	35.0%	35.0%	3-5	3	3-6	3-5%	4-5%	5-7%	1.4%	1.3%	1.5%
Chevron Texaco Corp	10.29-18.59	12.90-20.45	11.56-22.34	21.60%	24.4%	25.6%	2-7	2-7	2-7	4.6%	4.1%	5.8%	3.0%	3.0%	3.0%
Conoco Phillips	11.67	23.19	16.00	26.20%	27.0%	26.0%	6	5	5	4.1%	4.5%	5.9%	3.0%	2.5%	2.5%
Devon Energy	15.25	13.17	28.73	41.80%	42.2%	40.0%	5	5	5	3.2%	3.8%	5.5%	0.4%	0.6%	0.4%
EOG Resources	14.79	15.76	12.20	45.00%	43.0%	30.0%	5.3	6	6	3.7%	4.6%	6.0%	0.4%	0.5%	0.6%
Exxon Mobil	0.00	6.89	10.18	0.00%	16.0%	16.0%	0	6	6	0.0%	4.6%	5.5%	0.0%	2.5%	2.0%
Halliburton	6.89	19.11	21.57	63.00%	58.0%	54.0%	5	5	5	2.9%	4.5%	5.7%	2.7%	2.3%	1.3%
Kerr-McGee	16.97	22.54	19.15	36.00%	42.9%	31.3%	5.8	5.8	5.8	4.8%	5.0%	6.6%	3.4%	3.3%	3.1%
Nabors Industries	10.69	22.22	17.37	48.19%	50.4%	42.4%	3.5	3.5	3.5	3.8%	4.7%	6.0%	0.0%	0.0%	0.0%
Noble Corp	11.57	13.61	19.01	43.72%	41.4%	41.2%	5	5	5	4.4%	4.7%	5.7%	0.0%	0.0%	0.0%
Occidental	NA	NA	NA	31.70%	29.3%	28.4%	3.5	5	5	3.9%	4.8%	6.3%	3.9%	3.7%	5.0%
Rowan Companies	11.96	11.60	14.77	54.80%	55.5%	55.9%	3.3	3.2	3	2.1%	3.3%	5.3%	0.0%	0.0%	0.0%
Schlumberger	20.22	21.51	30.03	32-36%	32-35%	27-33%	5.07-6.8	5.02-5.51	5.49-7.15	4.34-5.25%	3.67-5.01%	5.75-6.84%	$0.75	$0.75	$0.75
Sunoco	7.08	10.38	6.95	29.30%	29.3%	28.1%	6	6	6	3.7%	4.8%	5.4%	3.3%	2.7%	3.6%
Transocean	12.25	16.26	15.21	45-51%	50-51%	46.0-47.0%	3.84	4	4	2.79-4.11%	4.13-5.25%	6.13-6.56%	0.0%	0.3%	0.3%
Unocal	9.35	35.00	29.00	32.70%	30.5%	40.7%	4.5	4.5	4.2	4.3%	4.6%	6.3%	2.2%	2.2%	2.5%
USX-Marathon Group	28.12	9.45	7.51	35.00%	34.0%	33.0%	5	5	5	4.5%	4.9%	6.5%	$0.92	$0.92	$0.88
Food & Drug Retailing															
Albertson's	6.80	10.16	6.34	38.00%	34.8%	32.5%	5.7	5.8	6	3.2%	3.6%	5.5%	3.8%	2.3%	3.5%
CVS	10.46	25.12	13.01	29.50%	29.8%	27.9%	7	7	6.5	4.0%	5.0%	6.3%	1.0%	0.8%	0.4%
Kroger	8.49	10.68	7.48	29.72%	29.1%	27.7%	8.4	8.3	8.1	4.4%	3.9%	4.9%	0.0%	0.0%	0.0%
Safeway	18.46	22.99	21.31	36.00%	34.0%	34.0%	7-9	7-9	7-9	4.4%	4.9%	6.2%	0.0%	0.0%	0.0%
SuperValu	7.77	4.85	4.37	34.66%	32.5%	30.4%	4.5	4.5	5	2.9%	4.2%	4.8%	2.0%	2.0%	2.0%
Sysco	8.81	7.98	6.14	22.00%	24.0%	23.0%	8	8	8	4.8%	6.3%	6.1%	1.3%	1.3%	1.2%
Walgreen	13.60	14.28	12.17	27.58%	26.0%	25.9%	7	7	7	4.6%	6.2%	6.6%	0.2%	0.2%	0.3%

S&P 500 Companies Options Information

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
Winn-Dixie Stores	7 55	3 09	6 62	35 10%	34 0%	38 0%	6 5	6 5	7	6 2%	6 2%	6 7%	3 9%	7 0%	5 4%
Food Beverage & Tobacco															
Altria Group	10 17	10 71	3 22	31 73%	33 8%	31 7%	5	5	5	3 9%	4 9%	6 6%	4 5%	4 7%	9 0%
Anheuser-Busch	13 86	12.76	13.14	23 00%	24 0%	22 0%	7	7	5	4.1%	4 9%	5 7%	1 6%	1 7%	1 4%
Archer Daniels Midland	4 31	3 79	3 20	40 00%	40 0%	30 0%	5	4	6	5 0%	7 0%	8 0%	2 0%	1 0%	2 0%
Brown-Forman	17 37	14 38	5 77-16 37	23 60%	24 0%	21 6%	6	6	6	4 8%	6 2%	5 9%	2.1%	2 2%	2 2%
Campbell Soup	8 09	7 96	7 94	31 00%	30 0%	29 0%	6	6	6	5 0%	5 1%	6 3%	2 2%	3 1%	3 0%
Coca-Cola	13 10	15.09	19 85	30 20%	31.9%	31 7%	6	5	5	3 4%	5 1%	5 8%	1 7%	1 6%	1 2%
Coca-Cola Enterprises	7 51	8 08	8 77	43 00%	40 0%	37 0%	6	6	6	4 8%	5 0%	6 8%	0 4%	0 4%	0 4%
Conagra Foods	5 08	5 75	6 21	29 00%	29 0%	20 6%	6	6	6	4 5%	5 2%	6 3%	3 9%	2 4%	2 2%
Coors Adolf	16 97	20 65	20 17	27 99%	30 7%	31 4%	5 4	5 4	6 2	4 4%	5 0%	6 7%	1 2%	1 0%	1 3%
General Mills	11 77	8 78	8 89	20 00%	20 0%	18 0%	7	7	7	5 1%	5 6%	6 3%	6 0%	8 0%	8 0%
Heinz	8 54	8 46	8 98	23 30%	23 5%	24 0%	6 5	6 5	5	4 6%	6 0%	6 1%	3 9%	3 8%	3 5%
Hershey Foods	20 96	18.58	15 58	28 00%	28 0%	27 0%	6.4	6 4	6 5	4.7%	5 0%	6 7%	1 9%	2 2%	1 8%
Kellogg	6 67	7 50	6 69	29 71%	28 2%	25 4%	3	3 08	3 17	3 6%	4 6%	6 6%	2 9%	3 3%	3 9%
McCormick & Company	4 99	5.06	3 32	21 60%	25 0%	24 5%	1 6-6 0	1 6-7 2	1 6-4 8	4 5%	5 0%	5 6%	2 0%	2 0%	2 0%
Pepsi Bottling Group	10 89	8 55	4 68	37 00%	35 0%	35 0%	6	6	7	4 5%	4 6%	6 7%	0 2%	0 2%	0 4%
Pepsico	15 20	13 53	12 04	27 00%	29 0%	29 0%	6	5	5	4 4%	4 8%	6.7%	1 14%	1.0%	1 1%
RJ Reynolds Tobacco	NA	NA	NA	NA	33 0%	33 0%	NA	4 2	4 2	NA	6 0%	6 0%	NA	0 0%	0 0%
Sara Lee	4 88	4 65	3 95	31 40%	33 6%	28 6%	4 2	3	4 3	4 3%	5 4%	6.2%	2 8%	2.8%	2 6%
UST	4 90	5 13	2 60	17 20%	30 3%	31 2%	7 5	7 5	7 5	4 9%	4 5%	6 1%	5 0%	6 5%	7 0%
Wrigley, William Jr	15 61	13 98	11 59	22 30%	23 8%	24 6%	6	6	6	4 9%	5 9%	4 8%	1 4%	1 6%	1 6%
Health Care Equipment & Svcs															
Aetna	15 06	11 68	16 43	40 00%	40 0%	39 0%	5	5	4	4.0%	5.0%	7 0%	0.1%	0 0%	1.0%
AmeriSource Bergen	25 96	27 00	6 60	33 5%-50 9%	40 7%-50 9%	40 7%-50 9%	5	5	5	3 69%-4 61%	4%-6 7%	4%-6 7%	0 0%-0 2%	0%- 2%	0%- 2%
Anthem Inc.	28.16	0.00	NA	45 00%	42 0%	NA	4 00	4	NA	4 2%	5 0%	NA	0 00%	0 0%	NA
Applera Corp	12 36	19 94	38 00	77 85%	71 9%	52 7%	4	4	4 12	3 6%	6 5%	5 9%	0 9%	0 6%	0 2%
Bard, C.R	14.15	13 24	15 67	33 00%	33 0%	32 0%	4 5	4 6	5.3	2 5%	4 3%	5 1%	1 6%	1 6%	2 0%
Bausch & Lomb	12 41	12 97	19 52	38 39%	48 2%	46 9%	5	3	3	2 9%	3 6%	5 1%	1 2%	2 3%	1 8%
Baxter Int'l	15 61	18 21	13 75	37 00%	36.0%	31 0%	6	6	6	4 1%	4 9%	6 1%	2 0%	1 0%	1 3%
Becton Dickinson	11 59	12 08	11 53	33 00%	32 8%	35 4%	6	6	6	4 5%	5 6%	6 6%	1 2%	1 1%	1 1%
Biomet	9 32	7 09	4 11	35 00%	36 0%	35 0%	4 8	3 6	3.6	2 4%	4 5%	6 3%	0.4%	0 4%	0 4%
Boston Scientific	19 15	12 70	8 67	49 80%	51 4%	47 2%	5	6	4 6	3 2%	4 9%	6 0%	0 0%	0 0%	0 0%
Cardinal Health	25 95	23 42	11 68	36 00%	38 0%	37 0%	5	4	4	3 8%	4.7%	6 3%	0 2%	0.2%	0 2%
CIGNA	22 13	22 34	19 35	29 40%	24 2%	26 2%	3 5	3	3	3 6%	5 0%	6 3%	1 5%	1 2%	1 5%
Guidant	17.58	19.14	26.25	38 90%	38.5%	35.5%	3-7	7	7	4 0%	5 1%	8 7%	0.0%	0 0%	0 0%
HCA	13 30	15 93	9 33	37 00%	38 0%	39 0%	4	6	6	2 2%	4 6%	4 9%	0 2%	0 2%	0 3%
HCR Manor Care	7 65	7 39	3 36	40 00%	46 0%	46 0%	4.6	3 8	4 2	4 1%	4.5%	6 2%	0 0%	0 0%	0 0%
Health Management	NA	NA	NA	53 60%	48 9%	48 6%	5	7	7	4 60%	5 5%	6 6%	0 0%	0 0%	0 0%
Humana	6 26	5.53	4.17	44.90%	44 7%	44 8%	5 8	6.4	7.5	4 9%	4 9%	6 7%	0 0%	0 0%	0 0%
IMS Health	4 84	7 20	6 23	36 00%	38 0%	40 0%	3	2 98	2 98	3 4%	4 1%	6 3%	0 3%	0 3%	0 3%
McKesson HBOC	12 22	13 17	11.33	31 50%	48 5%	46 0%	6	5	5	3 8%	4 7%	6 1%	0 5%	0 8%	1.5%
Medtronic	16 25	25 34	16 58	27 20%	37 8%	38 1%	7	7	7	4 5%	5 9%	6 1%	0 5%	0 4%	0 5%
Millipore	16.11	24 20	17.78	40 00%	45.0%	45 0%	5	5	5	4.2%	4 2%	5 3%	0 0%	0 0%	$0 44
Quest Diagnostics	33 74	25 79	14 97	45 20%	47 7%	43 7%	5	5	5	4 2%	5 1%	6 5%	0 0%	0 0%	0 0%

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
Quintiles Transnational	3 72	5 57	4 93	40 00%	40 0%	40 0%	0 85+V	83+V	0 86+V	2 1%	5 0%	5 1%	0 0%	0 0%	0 0%
St Jude Medical	12 95	12.85	10.55	35.00%	30 9%	35 6%	5	5	5	3 3%	4 4%	5 3%	0.0%	0 0%	0 0%
Stryker	22 94	21 76	14 82	37 40%	38 0%	37 0%	6 5	6 6	6 5	3 8%	5 0%	5 2%	0 2%	0 2%	0 3%
Tenet Healthcare	18 45	14.31	5 47	39 90%	39 0%	36 0%	6 8	7	6 6	4 5%	5 4%	5 9%	0 0%	0 0%	0 0%
United Health Group	26 00	23 00	14 00	40 20%	45 9%	49 0%	4 5	4 8	4 5	2 5%	3 7%	5 0%	0 1%	0 1%	0 1%
Well Point Health	18 85	14 46	13 09	35.00%	35 0%	40 0%	4	3-4	3-4	3 8%	4 53-4.66%	6.37-6 38%	0 0%	0 0%	0 0%
Zimmer Holdings	10 63	14 1	16 34	30 30%	41 7%	NA	5	7	NA	4 6%	4 8%	NA	0 0%	0 0%	NA
Hotels Restaurants & Leisure															
Carnival	12 16	12 67	13 31	48 00%	50 0%	28 9%	6	6	6	4 3%	4 5%	6 4%	1 23%	1 2%	1 2%
Darden Restaurants	12 25	11 69	4 31	30.00%	30 0%	30 0%	6	6	6	4 5%	7 0%	6 5%	0 1%	0.1%	0.1%
Harrah's Entertainment	17 34	12 33	14 30	32 00%	42 0%	42 0%	6	6	6	3 7%	4 3%	5 8%	0 0%	0 0%	0 0%
Hilton Hotels	NA	NA	NA	34 00%	48 0%	40 0%	5	6	7	4 6%	5 2%	6 0%	1 0%	1.0%	1 0%
Int'l Game Technology	22 29	16 74	10 06	42 00%	41 0%	43 0%	3 51	3 85	4 81	3 0%	4 3%	6 5%	0 0%	0 0%	0 0%
Marriott	14 00	16 00	15 00	32 00%	32 0%	30 0%	7	7	7	3 6%	4 9%	5 8%	$0 28	$0 26	$0 24
McDonald's	10 88	10 66	14 11	27 50%	29 9%	38 8%	7	7	7	5 3%	5 0%	6 4%	0 8%	0 7%	0 7%
Starbucks	6 49	8 96	5 37	43-54%	57 0%	55 0%	2-5	2-5	2-6	1 63-4 96%	2 37-5 90%	5 65-6,87%	0 0%	0 0%	0.0%
Starwood	13 58	17 45	13 38	46 00%	47 0%	46 1%	3	3	3	3 1%	4 3%	6 5%	2 7%	2 2%	2 4%
Wendy's Int'l	8 93-12 87	8.15	5 94	32-33%	34.0%	34.0%	2 7-4 9	4	4	3 8-4 7%	4 3%	6 1%	0 8%	0 9%	1 2%
Yum!Brands	10 44	7 1	6 74	33 90%	32 7%	32 6%	6	6	6	4 3%	4 7%	6 4%	0 0%	0 0%	0 0%
Household & Personal Prods															
Alberto-Culver	8 83	7 49	5 77	25 50%	25 4%	24 8%	5	5	5	3 5%-4 5%	4 6-5 9%	5 8%-6 5%	0 8%-1 0%	1-1 2%	1 1%-1 4%
Avon Products	19 09	12 05	11 73	45 00%	40 0%	40 0%	5	5	5	4 6%	4 7%	6 7%	2 0%	2 0%	2 0%
Clorox	11 53	12 76	12 43	38 40%	38 9%	36 5%	4-5	4-5	3-6	3 5-4 8%	4 6-6 5%	5 7-6 8%	2 1%	2 3%	1 8%
Colgate-Palmolive Co	9 50	9 37	10 95	21-41%	22-41%	22-41%	7-8	2-7	2-7	1.7-6 2%	3.3-6 2%	5 00-6 20%	2.0-2.5%	2 5%	2 5%
Gillette	11 18	9 44	10 58	33 10%	33 3%	33 4%	5 5	5 5	4 9	4 2%	5 4%	6 3%	1 8%	2 2%	2 0%
Kimberly Clark	16 57	19.87	16.24	26 91%	25.9%	26 2%	5 8	5 8	5.8	4 3%	4 7%	6 5%	2 0%	1 6%	2 4%
Procter & Gamble	21 14	22 45	37 21	20 00%	26 0%	28 0%	12	9	9	5 4%	5 8%	6 0%	2 2%	2 0%	1 5%
Insurance															
ACE Limited	NA	NA	NA	35 20%	42 8%	40 1%	4	4	4	4 0%	4 8%	6 4%	1 4%	1 7%	2 2%
AFLAC	NA	NA	NA	31 90%	32 4%	32 0%	4 3-5 5	4 4-5.5	4 2-5 8	5.0%	5.0%	6 0%	0 8%	0 8%	0 5%
Allstate	8 81	12 48	6 21	30 00%	30 0%	30 0%	6	6	6	4 9%	5 2%	5 1%	2 5%	1 6%	1 6%
AMBAC Financial Group	20 61	17 37	11 78	31.90%	32.7%	30 3%	5	5	5	4 2%	4 8%	6 5%	0.6%	0 7%	0 9%
American Int'l Group	24 65	24 30	38 76	34 00%	28 0%	27 0%	7	7	7	4 3%	5 1%	5 4%	0 3%	0 2%	0 2%
AON	6 21	8 66	6.33	21 00%	28 0%	27 0%	0 96+V	1.06+V	0 94+V	4 0%	6.0%	6 0%	2 3%	2 0%	2 0%
Chubb	17 91	18 22	11 98	27 00%	25 7%	21 9%	5	5 5	5 5	4 3%	4 7%	6 7%	2 0%	1 9%	2 7%
Cincinnati Financial Cp	12.58	13.31	10 56	25 90%	25 5%	24 9%	10	10	10	4 3%	5 5%	5 3%	2 5%	2 2%	2 1%
Hartford Finl	25 20	24 86	17 60	40 80%	29 1%	35 7%	6	6	4	4 3%	5 0%	6 4%	1 6%	1 6%	1 5%
Jefferson-Pilot	10 73	11.27	8.96	22.00%	22 0%	20 0%	7.9	8 1	8 6	5 0%	5 2%	6.7%	+10.0%	+10 0%	+10 0%
John Hancock	7 70	9 24	3 66	28 80%	32 0%	24 0%	3	3-5	2-5	2 5%	4 6-6 0%	4 8%-5 6%	1 1%	1 0%	1 8%
Lincoln National	16 03	13.44	8.33	39.60%	40.0%	39 2%	4 2	4 2	4.9	4 5%	4 8%	6 6%	2 5%	2 8%	4 4%
Loews	18 68	16 90	10 73	29 20%	35 2%	33 4%	5	5	5	5 4%	5 3%	6 7%	1 0%	1 1%	1 6%
Marsh & Mclennan	16 82	13 99	13 35	33 20%	32 7%	26.3%	5	5	5	4 9%	4 8%	6.5%	2.3%	2.0%	2 0%
MBIA	17 19	16 11	15 74	31 66%	29 5%	28 3%	6 4	6 25	6 18	3 3%	5 1%	5 3%	1 9%	1 1%	1 1%
Metlife	10.48	10.29	NA	25.3-30 3%	31.8%	NA	4-5	4-6	NA	4.74-5 52%	5 7%	NA	0 7%	0 7%	NA

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
MGIC Investments	27 15	24 43	21 96	41 96%	39 6%	33 6%	5	5	6 8	4 5%	5 1%	6 8%	0 2%	0 2%	0 2%
Progressive	NA	NA	NA	39 50%	37 7%	31 4%	6	6	6	4.7%	5 2%	6.4%	0.3%	0 3%	0 5%
Prudential Financial	11 87	8 78	NA	33 33%	37 0%	NA	6 00	4	NA	4 0%	4 1%	NA	1 05%	1 0%	NA
Safeco	8 00	7.00	6.00	35 00%	35 0%	33 0%	4	4	7	2 6%	4 5%	5 0%	2.5%	2 5%	3 5%
St Paul Companies	14 02	14 94	10 58	34 20%	33 8%	30 0%	6 9	6 8	6 5	4 9%	5 0%	6 5%	2 9%	3 0%	3 0%
Torchmark	10 33	13.00	12 05	30 10%	31 7%	32 5%	4 51	4 75	4 77	3 1%	4 5%	5 1%	1 0%	0 9%	1.0%
Travelers Property	5 84	NA	NA	36 80%	NA	NA	4 00	NA	NA	3 2%	NA	NA	$0 20	NA	NA
UnumProvident	7 56	7 87	2 73	24 80%	26.3%	24 2%	6	6	6	4 5%	5 0%	5 6%	$0 59	$0 59	$0 59
XL Capital	NA	NA	NA	30 90%	26 0%	25 8%	5	5	7 5	4 6%	4 7%	5 0%	2 0%	2 3%	3 6%
Materials															
Air Products &	NA	NA	NA	30 10%	29 2%	28 4%	7 8	7 6	6 6	4 7%	5 9%	6 2%	2 0%	2 1%	2 0%
Alcoa	9 96	9 54	10 13	42 00%	43 0%	40 0%	2.5-3 0	2 0-2 5	2-2 5	3 5%	3 8%	6 1%	2 1%	1 6%	1 6%
Allegheny Technologies	2 95	4 89	5 38	35 00%	39 0%	36 0%	8	8	8	4 0%	4 8%	5 5%	4 4%	4 7%	4 3%
Ball	16 57	7.80	6 08	34 92%	33 8%	32 4%	4.75	5 25	5 5	4 6%	4 8%	6 4%	0.7%	0 9%	1.3%
Bemis	20 08	12 92	11 82	29 00%	29 5%	28 3%	10	10	8 0	6 8%	7 0%	7 0%	2 1%	2 9%	2 7%
Boise Cascade	7 12	10 21	7 61	40.00%	30 0%	30 0%	4 3	4 3	4 2	4 0%	5 4%	6.0%	$0.60	$0 60	$0 60
Dow Chemical	10 65	13 65	13 23	42 75%	47 0%	35 8%	7	7	7	4 2%	4 7%	6 5%	4 4%	3 8%	3 3%
Du Pont	11 01	10 77	13.40	27.20%	26 4%	25 4%	6 5	6 5	6 2	4.9%	5 1%	6 1%	3 2%	3 2%	3 0%
Eastman Chemical	11 16	10 95	11 06	27 57%	27 1%	27 0%	6	6	6	5 1%	4 7%	6 2%	3 7%	3 7%	3 8%
Ecolab	14.21	11.26	11 50	26 50%	24 8%	19 6%	6	6	6	3 6%	4 7%	6 2%	1.1%	1.3%	1.1%
Engelhard	8 62	8 13	4 28	3 60%	35 0%-36 0%	33 0%	5-6	5	4-5	3 1-3 8%	3 8%-5 1%	6 0%	1 4-1 8%	1 5%-1 8%	2 1-2 4%
Freeport McMoran	7.89	6 30	9 44	47 00%	47 0%	44.0%	7	7	7	5 0%	5 2%	6.7%	0 0%	0 0%	0 0%
Georgia Pacific	11 84-13 21	15 46	23 26	45 00%	47 0%	42 0%	10	10	10	4 9-5 0%	5 2%	6 7%	1 9-2 1%	1 7%	1 2%
Great Lakes Chemical	7 24	10 81	11 67	28 90%	27 6%	28 3%	6.5	6 5	6 5	4 7%	4 4%	6 7%	1 5%	1 1%	1 1%
Hercules	5 09	5 90	7 19	34 60%	35 5%	35 5%	6	8	6	5 0%	5 2%	6 3%	0 0%	0 0%	0 0%
Int'l Flav. & Frag	10 07	8.09	5 50	33.70%	32.2%	26 9%	5	5	5	4 5%	4 6%	6 2%	1.8%	2.2%	3.8%
Int'l Paper	8 59-8 77	9 02-9 45	11 86-13 44	33 99-38 62%	39 51-41 02%	45 0%	1 80-3 50	2 10-3 00	2 1-2 5	2 92-3 29%	3 91-4 40%	6 17-6 45	2 33-2 74%	2 61-2 64%	2 5%
Louisiana-Pacific	3 08	3 42	4 67	45.00%	42 0%	34 0%	term	term	term	5 4%	5 3%	6 8%	2 3-4 6%	2 3%-4 6%	2 3-4 6%
MeadWestVaco Corp	10 11	7 05	7 65	36 00%	25 0%	22 0%	6	6	6	4 7%	5 6%	6 1%	3 0%	3 2%	2 9%
Monsanto Co	9 53	8 46	7.24	44 60%	45 3%	43 7%	3 50	3 5	3 5	3 8%	4 4%	5.7%	1 88%	1 5%	2 0%
Newmont Mining (Hldg	12 66	12 98	12 55	51 00%	49 0%	56 0%	8	9	9	3 4%	4 9%	6 4%	0 5%	0 6%	0 6%
Nucor	18 69	14 59	16 54	49 03%	41.0%	40 6%	3.5	3.5	3.5	2 32-4 14%	3 45-4.43%	6.02-6.53%	1.6%	1.4%	1 7%
Pactiv	6 17	6 15	4 57	38 70%	41 1%	36 6%	4 4	4 4	5	3 0%	4 3%	5 9%	0 0%	0 0%	0 0%
Phelps Dodge	9 76	6.04	13.47	38 80%	40 9%	39.0%	3	3	3	3.3%	3 4%	5 4%	3 0%	3 2%	3 3%
PPG Industries	12 40	11 93	13 08	32 40%	26 3%	24 5%	4 3	4 3	5 7	4 1%	5 2%	6 1%	2 8%	2 7%	2 6%
Praxair	21 37	16.15	15 46	35 80%	35 6%	33.0%	6	5	5	4 5%	4 7%	6 4%	1 2%	1.2%	1.0%
Rohm & Haas	13 12	10 74	12 62	33 18%	33 8%	28 9%	6	6	6	5 0%	5 0%	6 6%	2 2%	2 4%	1 9%
Sealed Air	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Sigma-Aldrich	16 22	15 47	17 66	30 50%	30 4%	47 1%	6 1	6 5	6 3	2 9%	4 8%	5 1%	0 8%	0 9%	0 9%
Temple Inland	16 31	16 05	16 63	29.30%	29 3%	29.7%	8	8	8	3.8%	5 1%	5 1%	2.5%	2 4%	2 7%
USX-U S Steel Group	8 29	7 69	6 63	43 00%	40 0%	37 0%	5	5	5	4 4%	4 9%	6 5%	$0 20	$0 20	$1 00
Vulcan Materials	8 37	7.26	8 25	23 25%	23 8%	25 5%	7	5	5	4 7%	4 9%	6 8%	2 0%	2 0%	2 0%
Weyerhaeuser	16 43	13 09	12 99	29 92%	29 3%	29 0%	5 2	4 7	3 8	4 9%	5 1%	6 5%	2 6%	3 0%	3 0%
Worthington Industries	2 89	2.27	2.84	23 00%	23.0%	23 0%	5	5	5	4 4%	3 6%	6 0%	4 6%	6.4%	4 3%
Media															

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
AOL Time Warner	9 65	24 89	21 07	52 90%	59 3%	46 3%	47+V	5	5	4 1%	4 8%	6 2%	0 0%	0 0%	0 0%
Clear Channel Comm	18 00	25.00	29 00	36%-49%	36%-37%	34.0%	3 5-7.5	6-8	8	2 85-5.33%	5 2-4 9%	6.0%	0 0%	0.0%	0 0%
Comcast Corp	14 93	19 07	21 20	29 2-29 6%	35 7%	35 8%	8	8	8	4 0-5 1%	5 1%	6 3%	0 0%	0 0%	0 0%
Dow Jones	13 55	15.66	18 37	25.70%	25.7%	25 5%	5	5	5	4 4%	5 0%	6.7%	2.3%	1.9%	2 1%
Gannett	21 48	22 58	19 63	26 12%	26 4%	27 0%	7	7	7	3 9%	4 6%	5 6%	1 3%	1 3%	1 3%
Interpublic	9 76	12 55	14.86	35 79%	30 4%	25 9%	6	6	6	4 7%	4 9%	6 2%	1 6%	1 2%	0 9%
Knight-Ridder	11 65	10 53	11 29	21 40%	21 0%	20 0%	4 3	3	4	3 0%	4 3%	6 1%	1 6%	1 6%	1 8%
McGraw-Hill Companies	19 87	16 76	15.70	29 00%	28 0%	28 0%	5	5	5	5 1%	4 7%	6 6%	1 8%	1 7%	1 7%
Meredith	11 19	10 98	11 59	24 00%	23 0%	22 0%	6 5	7 3	6 5	4 6%	5 2%	6 2%	0 8%	0 8%	0 8%
New York Times	12 28	13 69	13 94	30.95%	31 5%	34 1%	5	5	4-5	3 0%	4 5%	5 00-5 06%	1 2%	1 1%	1 1%
Omnicom Group	28 01	21 45	24 85	28 20%-35 30%	28 58-30 79%	21 88-26 49%	5	5	5	2 4-4 7%	4 0-4 9%	4 96-6 67%	0 9-1 3%	0 9-1 4%	6- 9%
Tribune Co	11 83	12 58	12 31	28 6-31.8%	31 3-37.3%	29 3%	2-5	2-5	5	3-4 5%	4 6-5 0%	6 8%	1 0%	1 0%	1 0%
Univision	14 03	17 49	17 86	49 31%	45 4%	50 0%	6	6	6	3 5%	4 4%	6 1%	0 0%	0 0%	0 0%
Viacom	20 04	23 71	27 39	37.03%	33 7%	32 1%	6 7	6 7	6 8	5 0%	5 0%	6 6%	0 0%	0.0%	0 0%
Walt Disney	8 02	10 25	12 49	30 00%	27 0%	26 0%	6	6	6	4 8%	5 0%	6 5%	1 0%	0 7%	0 6%
Pharmaceuticals & Biotech															
Abbott Labs	16 47	13 31	10 60	28 00%	27 0%	26 0%	5 4	5 4	5 4	4 5%	4 9%	6 8%	1 6%	2 0%	2 0%
Allergan	22 33	23 55	21 40	32 00%	33 0%	34 0%	5	5	5	4 5%	4 8%	6 6%	0.5%	0 5%	0 6%
Amgen	16 66	26 74	25 87	50 00%	50 0%	45 0%	3 9	3 7	3 4	3 6%	4 7%	5 9%	0 0%	0 0%	0 0%
Biogen	24 65	31.77	24 34	45.00%	44 0%	45 0%	7.4	7.5	5.5	5 8%	5 5%	6 9%	0 0%	0 0%	0 0%
Bristol-Myers Squibb	11 12	22 59	17 17	31 30%	28 6%	24 5%	7	7	7	5 0%	5 8%	6 3%	3 0%	1 5%	1 5%
Chiron.	22 78	28 84	28 85	62.00%	61 0%	61 0%	5	5	5	2 8%	4 4%	5 0%	0 0%	0 0%	0 0%
Forest Laboratories	30 64	31 60	14 27	27 62%	43 6%	38 3%	5-10	5-10	5-10	5 4%	4 9-6 5%	6 0%	0 0%	0 0%	0 0%
Genzyme Corporation	16 77	25.66	26 62	54 00%	49 0%	48 0%	5	5	5	4 6%	5 1%	6 8%	0.0%	0.0%	0 0%
Johnson & Johnson	15 49	13 72	14 79	26 00%	27 0%	27 0%	5	5	5	4 4%	4 9%	5 5%	1 3%	1 3%	1 4%
King Pharmaceuticals	NYA	19.38	21 45	NYA	62 4%	64.2%	NYA	4	4 23	NYA	3 6%	5.9%	NYA	0 0%	0.0%
Lilly Eli & Co	25 98	26 59	29 25	35 00%	33 1%	32 7%	7	7	7	3 1%	4 6%	5 0%	1 5%	1 8%	2 3%
Medimmune	20 56	26 18	44.03	53.00%	69 0%	69 0%	6	6	7	4 2%	4 7%	6 2%	0 0%	0 0%	0 0%
Merck & Co	17 53	25 42	23 28	31 00%	29 0%	28 0%	5 7	6 7	6 6	4 3%	4 8%	6 5%	2 3%	1 7%	1 8%
Pfizer	12 58	15 12	11 12	32.41%	31 5%	30 7%	5 3	5 5	5 35	4 4%	5 0%	6.7%	1 9%	1 4%	1 5%
Schering-Plough	11 25	13 35	13 82	35 00%	35 0%	32 0%	5	5	5	4 3%	4 9%	6 3%	1 3%	1 5%	1 7%
Watson Pharmaceuticals	10 75	21.49	21 38	38.00%	65 0%	58 0%	5 1	4 6	5.9	4 2%	4 8%	6.1%	0.0%	0 0%	0.0%
Wyeth	16 12	17 76	18 76	33 70%	32 1%	31 2%	5	5	5	4 1%	4 8%	6 3%	1 9%	1 6%	1 6%
Real Estate															
Apartment Invtmt &	3 52	3 92	4 65	21 00%	19 3%	19 2%	4 5	4 5	4 5	4 2%	4 4%	6 1%	7 5%	6 9%	6 8%
Equity Office Properties	2.29	2.76	5 63	19.00%	21.0%	33 0%	5	5	5	4.2%	4 2%	5 1%	7.0%	6 7%	5.5%
Equity Residential	NA	NA	NA	20 80%	20 4%	20 7%	7	7	7	4 6%	4 4%	6 2%	6 5%	6 2%	6 8%
Plum Creek Timber Co.	4 21-4 33	NA	7 35	31 00%	24-34%	38 0%	7	5-7	10	3 5-4 8%	4 4-6 5%	6 7%	6 0-7 7%	4 0-9 1%	4 4%
Simon Property Group	2 78	1 82	1 57	18 70%	20 45-20 58%	20-20 01%	6 00	10	10	4 9%	4 85-5 33%	6 08-6 47%	6 90%	7 36-7 83%	8 68-7 76%
Retailing															
AutoNation	4 78	4 54	2 96	40 00%	40 0%	40 0%	5 7	5-7	5-7	2 79-3 55%	4 44-4 92%	5 07-5 15%	0 0%	0 0%	0 0%
AutoZone	16.10	10 19	11.92	39.00%	34-37%	34.0-37 0%	4.79-8 79	4 83-8.83	4 83-8 83	2 15-3.21%	3 75-6.18%	3 75-6.18%	0 0%	0.0%	0 0%
Bed Bath & Beyond	12 77	7 25	8 34	45 0%	45 0%	42 0%	7	7	7 0	4 8%	6 6%	6 0%	0 0%	0 0%	0 0%
Best Buy	18 60	23 06	17 06	55 0%	60 0%	50.0%	4.5	4 5	4 5	4 9%	6 1%	6 4%	0 0%	0.0%	0 0%

S&P 500 Companies Options Information

	Wtd. Avg. Fair Value at Date of Grant			Option Valuation Assumptions:											
				Volatility			Expected Life			Interest Rate			Dividend		
Company	2002	2001	2000	2002	2001	2000	2002	2001	2000	2002	2001	2000	2002	2001	2000
Big Lots	6 51	11 53	11 76	54 80%	51 2%	66 0%	5 4	4 1	5 5	4 3%	4 5%	4 8%	0 0%	0 0%	0 0%
Circuit City Group	**7.00**	**17.00**	**17 00**	**62 0%**	**49 0%**	**38 0%**	**5**	**5**	**5 0**	**5 0%**	**6 0%**	**6 0%**	**0 6%**	**0.2%**	**0 2%**
Costco Companies	17 83	15 47	20 35	46 00%	43 0%	42 0%	5	5	5	4 5%	5 0%	6 6%	0 0%	0 0%	0 0%
Dillard's	**6 91**	**3.91**	**3 01**	**41 60%**	**44 0%**	**38 7%**	**3.1**	**2**	**3 3**	**2 0%**	**2 3%**	**4 5%**	**0 7%**	**1 0%**	**1.5%**
Dollar General	6 15	6 77	10 76	35 30%	35 3%	49 0%	6 5	6	6 8	3 9%	4 8%	6 2%	0 8%	0 8%	0 7%
Ebay	**22 42**	**23 67**	**42 44**	**68 00%**	**81 0%**	**115 0%**	**3 00**	**3**	**3**	**3 0%**	**4 4%**	**6 3%**	**0 00%**	**0 0%**	**0 0%**
Family Dollar Stores	8 61	6 37	5 82	44 31%	41 4%	35 3%	3 5	3 5	3 5	4 0%	6 0%	6 0%	1 0%	1 3%	1 0%
Federated Dept. Stores	**20 73**	**19 62**	**14 33**	**41 50%**	**39 1%**	**37 0%**	**6**	**6**	**6**	**5 2%**	**4 6%**	**6 3%**	**0 0%**	**0 0%**	**0.0%**
Gap	5 41	5 74	11 42	43-56%	43-47%	39-43%	0 83-8 9	1 75-6 2	3 3-8 4	1 1-4 2%	1 3-5 3%	4 1-5 2%	0 6%	0 6%	0 3%
Genuine Parts	**5 72**	**6.91**	**2 71**	**22.00%**	**26 0%**	**18 0%**	**8**	**5**	**6**	**4 1%**	**5 0%**	**5 9%**	**4 0%**	**3 8%**	**5.0%**
Home Depot	17 34	20 51	31 96	44 30%	48 1%	54 6%	5	6	7	4 0%	5 1%	6 4%	0 5%	0 4%	0 3%
Kohl's	**26 24**	**34 78**	**30.00**	**30-40%**	**30-40%**	**30 0%**	**6-8**	**7-8**	**7-8**	**4 0-6 0%**	**4 75-6 0%**	**5-6%**	**0.0%**	**0 0%**	**0 0%**
Limited Brands	5 31	5 84	5 19	42 00%	41 0%	36 0%	4 4	4 5	4 3	3 0%	4 0%	5 0%	2 8%	2 3%	2 3%
Lowe's Companies	**19 22**	**17 39**	**11.57**	**43.70%**	**41 1%**	**37.7%**	**4.0-7.0**	**7**	**7**	**4 4%**	**4.6%**	**5.2%**	**0 3%**	**0 2%**	**0 4%**
May Department Stores	11 00	11 00	8 00	32 00%	32 0%	32 0%	7	7	7	5 1%	4 6%	6 4%	$0 95	$0 94	$0 93
Nordstrom	**14 00**	**10 00**	**12 00**	**69 00%**	**68 0%**	**65 0%**	**5**	**5**	**5**	**4 3%**	**4 8%**	**6 4%**	**1 5%**	**1 3%**	**1 0%**
Office Depot	6 38	3 92	4 18	40 00%	40 0%	40 0%	4 4	4 9	5 6	4 7%	4 6%	6 4%	0 0%	0 0%	0 0%
Penney, J C	**6 32**	**4 36**	**3 78**	**40 00%**	**40 2%**	**35 2%**	**7**	**5**	**5**	**4 7%**	**4 8%**	**6 2%**	**3 9%**	**4.2%**	**4 2%**
Radioshack	13 53	15 64	17 79	46 10%	42 3%	37 1%	6	6	6	4 5%	4 9%	6 5%	$0 22	0 7%	1 6%
Sears	**23 05**	**14.47**	**12 98**	**41 00%**	**31 0%**	**31 0%**	**8**	**8**	**8**	**4 6%**	**4 9%**	**6 6%**	**1.9%**	**1 6%**	**1 6%**
Sherwin-Williams	5 48	5 36	4 72	33 30%	35 3%	30 5%	3	3	3	2 2%	4 0%	6 3%	2 2%	2 0%	2 0%
Staples	**6 84**	**5.32**	**5 54**	**45 00%**	**37.0%**	**43 0%**	**5**	**4**	**4**	**4 0%**	**4 5%**	**4 8%**	**0 0%**	**0 0%**	**0 0%**
Target	10 07	13 09	11 15	35 00%	30 0%	30 0%	5	5	5	3 0%	4 3%	4 8%	0 8%	0 6%	0 6%
Tiffany & Company	**9 40**	**12.33**	**12 14**	**37 50%**	**36 5%**	**35 0%**	**5**	**5**	**5**	**2.9%**	**4 3%**	**4 9%**	**0 6%**	**0 7%**	**0 7%**
TJX Companies	8 93	8 46	5 04	44 00%	46 0%	48 0%	6	6	6	3 5%	5 0%	5 2%	0 5%	1 0%	1 0%
Toys R Us	**6.42**	**9.16**	**5 88**	**40 7-50.7%**	**40 7-56 7%**	**43.4-58 5%**	**5**	**5**	**5**	**2 6-5 0%**	**3 6-5 1%**	**5-6 8%**	**0.0%**	**0.0%**	**0.0%**
Wal Mart Stores	18 00	24 00	22 00	23 0-41 0%	23-41%	23 0-41 0%	3-7	5 8-7 4	2-5 8	2 5-7 2%	4 4-7 2%	4 4-7 2%	4-1 3%	4-1 3%	4-1 3%
Software & Services															
Adobe Systems	13 49	15 20	29 89	69 00%	80 0%	68 0%	3	3	3	2 1-4 1%	2 9-5 3%	5 7-6 8%	0 1%	0 1%	0 1%
Autodesk	**7 82**	**8 93**	**8.75**	**60 00%**	**60 0%**	**60 0%**	**5**	**5**	**5**	**3 0%**	**4 8%**	**5 7%**	**0.8%**	**0 7%**	**0 8%**
BMC Software	11 45	15 37	23 56	75 00%	70 0%	50 0%	5	5	5	4 6%	4 8%	6 7%	0 0%	0 0%	0 0%
Citrix Systems	**5.80-8 57**	**16 63**	**28.07**	**69 00%**	**60.0%**	**80.0%**	**4.6**	**4.68**	**4.64**	**4.0%**	**5 0%**	**6.0%**	**0.0%**	**0.0%**	**0.0%**
Computer Associates	13 48	17 10	27 98	65 00%	65 0%	50 0%	6	6	6	4 9%	6 1%	5 6%	0 4%	0 3%	0 2%
Computer Sciences	**14 54**	**34.14**	**23 59**	**47 00%**	**44 0%**	**36 0%**	**6 33**	**6 15**	**6 08**	**4 7%**	**6 1%**	**5 7%**	**0 0%**	**0 0%**	**0 0%**
Compuware	5 09	7 30	15 52	64 55%	95 6%	85 9%	4 1	5	4 8	4 7%	4 6%	6 4%	0 0%	0 0%	0 0%
Electronic Arts	**18.88**	**18.31**	**10 00**	**72 00%**	**74.0%**	**65 0%**	**2 25**	**2.32**	**2.29**	**2.22-4.51%**	**4 59-6.55%**	**4 93-6 94%**	**0 00%**	**0.0%**	**0 0%**
Electronic Data Systems	19 59	23 09	19 00	42 70%	38 6%	39 9%	3 8	5 7	3 9	4 5%	4 8%	6 3%	1 1%	1 0%	1 2%
Intuit	**20 31**	**10 43**	**23 27**	**74 00%**	**76 0%**	**73 0%**	**1.89-4 89**	**1 73-4 73**	**1 75-4 75**	**1 23-5 47%**	**3 51-5 03%**	**5 61%-6 8%**	**0 0%**	**0 0%**	**0 0%**
Mercury Interactive	19 44	27 03	37 02	90 00%	92 0%	88 0%	4	4	4	4 2%	4 6%	6 3%	0 0%	0 0%	0 0%
Microsoft	**31.57**	**29.31**	**36 67**	**39.00%**	**39 0%**	**33 0%**	**7**	**6 4**	**6.2**	**5.4%**	**5 3%**	**6 2%**	**0 0%**	**0.0%**	**0.0%**
Novell	1 70	3 52	11 09	87 00%	82 0%	75 0%	5	5	5	3 6%	4 8%	6 3%	0 0%	0 0%	0 0%
Oracle	**7 45**	**18 86**	**7 84**	**57 00%**	**76 0%**	**67 0%**	**1.26-2 51**	**21-.78**	**45-8 31**	**3 45-4 48%**	**4 09-6 56%**	**5 28%-6 72%**	**0 0%**	**0 0%**	**0 0%**
Parametric Technology	3 25	5 86	7 46	75 00%	75 0%	50 0%	6	6	6	4 9%	5 0%	6 2%	0 0%	0 0%	0 0%
Peoplesoft	**13.48**	**15 09**	**8 21**	**92 00%**	**70 0%**	**65.0%**	**3 23**	**2.88**	**2.43**	**3.6%**	**4.6%**	**6 2%**	**0 0%**	**0 0%**	**0.0%**
Siebel Systems	9 77	16 15 20	13-34 37	65 00%	89 3%	77 0%	3 4	3 4	3 4	2 0%	3 8%	6 1%	0 0%	0 0%	0 0%

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
Sungard Data Systems	17.26	15.47	10.23	52.00%	48.0%	54.0%	6.00	6	6	3.1%	4.7%	5.0%	0.00%	0.0%	0.0%
Symantec Corp	20.66	12.70	13.62	75.00%	71.0%	65.0%	5.62	5.01	4.99	4.6%	4.5%	6.5%	0.0%	0.0%	0.0%
Unisys	5.95	9.80	18.76	55.00%	55.0%	55.0%	5	5	5	4.4%	5.1%	6.8%	0.0%	0.0%	0.0%
Veritas Software	13.92	28.58	63.42	90.00%	90.0%	70.0%	5	5	5	3.8%	4.6%	6.2%	0.0%	0.0%	0.0%
Yahoo!	NA	NA	55.04	77.00%	79.0%	76.0%	3	3	3	2.2-4.1%	3.1%-4.8%	5.6-6.7%	0.0%	0.0%	0.0%
Technology Hardware & Equip															
ADC	2.27	8.74	13.98	67.02%	93.2%	82.9%	4.3	4.4	4.5	2.4%	3.3%	5.9%	0.0%	0.0%	0.0%
Advanced Micro Devices	2.26	3.82	5.54	84.68%	83.4%	72.1%	3.17	3.02	4.27	2.9%	3.6%	6.6%	0.0%	0.0%	0.0%
Agilent Technologies	15.00	45.00	48.00	63.00%	77.0%	67.0%	5.5	5.5	7	2.9%	4.3%	5.8%	0.0%	0.0%	0.0%
Altera	7.19	13.94	19.06	71.70%	63.8%	57.3%	3.3	1.01+V	96+V	2.9%	4.4%	6.2%	0.0%	0.0%	0.0%
Analog Devices	18.89	26.95	16.90	70.50%	65.4%	56.6%	5.2	5.3	4.9	3.5%	5.7%	6.0%	0.0%	0.0%	0.0%
Andrew Corp	10.40	11.38	12.22	53.80%	52.3%	49.9%	6	6	6	4.1%	4.6%	5.7%	0.0%	0.0%	0.0%
Apple Computer	10.11	10.15	25.92	64.00%	66.0%	67.0%	4	4	4	2.9%	4.9%	6.2%	0.0%	0.0%	0.0%
Applied Materials	10.87	8.98	13.05	69.00%	67.0%	63.0%	3.6	3.4	3.9	3.6%	3.8%	6.0%	0.0%	0.0%	0.0%
Applied Micro Circuits	13.36	52.86	20.14	105.00%	133.0%	82.0%	4	4	4	4.5%	6.0%	6.0%	0.0%	0.0%	0.0%
Avaya	3.14	5.86	15.75	51.50%	50.4%	38.4%	3.9	3.3	2.8	4.3%	5.7%	6.3%	0.0%	0.0%	0.2%
Broadcom	9.33	27.13	93.31	70.00%	90.0%	90.0%	4	3	3	2.7%	4.1%	6.2%	0.0%	0.0%	0.0%
Ciena Corp	4.88	27.92	64.99	92.00%	131.0%	106.0%	4.5	2.6	2.7	2.6%	3.6%	6.1%	0.0%	0.0%	0.0%
Cisco Systems	8.60	13.31	19.44	47.50%	34.8%	33.9%	5.5	3.6	3.1	4.7%	5.4%	6.4%	0.0%	0.0%	0.0%
Comverse Technology	4.66	10.85	50.38	75.00%	76.0%	65.0%	2.6	4.3	4.9	1.8%	4.0%	5.5%	0.0%	0.0%	0.0%
Corning	3.64	13.83	38.46	80.00%	75.0%	65.0%	5	6	5	4.0%	4.8%	5.8%	0.0%	0.5%	0.4%
Dell	11.41	13.04	20.98	43.00%	61.2%	54.9%	5	5	5	3.8%	4.6%	6.2%	0.0%	0.0%	0.0%
EMC	3.69	11.91	42.28	55.00%	55.0%	55.0%	5	5	5	3.4%	4.4%	6.2%	0.0%	0.0%	0.0%
Gateway	3.30	8.09	36.76	71.00%	73.0%	60.0%	3.5	3.5	3.5	1.5-6.6%	2.20-6.60%	4.50-6.60%	0.0%	0.0%	0.0%
Hewlett-Packard	8.64	12.30	24.40	39.00%	39.0%	34.0%	7	7	7	4.8%	5.1%	6.9%	1.8%	1.4%	0.7%
IBM	28.00	42.00	36.00	40.40%	37.7%	32.0%	5	4-5	4-5	2.8%	4.4%	5.1%	0.7%	0.5%	0.5%
Intel	10.89	12.62	28.27	49.00%	47.0%	42.0%	6	6	6.5	3.7%	4.9%	6.2%	0.3%	0.3%	0.1%
Jabil Circuit	10.72	18.02	16.61	91.00%	94.0%	91.0%	5	4	4	4.2%	5.0%	5.8%	0.0%	0.0%	0.0%
JDS Uniphase	4.13	26.81	27.92	79.00%	78.0%	70.0%	5	5	5.5	4.3%	5.0%	6.0%	0.0%	0.0%	0.0%
KLA-Tencor	21.87	25.93	24.15	80.00%	80.0%	70.0%	5.4	5.4	5.3	4.4%	5.5%	6.3%	0.0%	0.0%	0.0%
Lexmark	24.14	23.02	47.05	50.00%	48.0%	46.0%	4.8	4.9	5	4.2%	4.9%	6.6%	0.0%	0.0%	0.0%
Linear Technology	25.59	31.64	24.26	69.00%	65.8%	59.1%	6.1	6.5	6.5	4.4%	5.0%	5.9%	0.5%	0.2%	0.3%
LSI Logic	8.29	15.44	30.86	77.00%	76.0%	108.2%	3.84	3.79	3.85	4.0%	4.7%	6.3%	0.0%	0.0%	0.0%
Lucent	2.11	4.59	16.15	78.90%	60.2%	39.2%-55.3%	2.5	2.4	2.9	3.6%	4.9%	6.5%	0.0%	0.5%	0.2%
Maxim Integrated	19.58	23.86	22.38	61.00%	59.0%	54.0%	4.5	4.5	4.6	4.4%	5.1%	5.9%	0.0%	0.0%	0.0%
Micron Technology	15.61-16.92	14.54-18.77	19.50	78.00%	69.0%	64.0%	7.5	3.5	3.5	4.7%	4.9%	6.3%	0.0%	0.0%	0.0%
Molex	14.69-16.04	18.23	15.78	52.02%	58.9%	41.3%	4.65	4.31	4.2	5.6%	5.9%	6.0%	0.2%	0.2%	0.2%
Motorola	5.04	7.00	15.00	45.10%	45.9%	39.8%	5	5	5	3.8%	4.5%	6.1%	1.3%	1.0%	0.5%
National Semiconductor	17.49	15.88	36.36	75.00%	73.0%	64.0%	5.10	5.7	5.8	4.5%	5.0%	6.6%	0.00%	0.0%	0.0%
NCR	14.84	18.53	17.42	45.00%	40.0%	40.0%	5	4.9	5	3.9%	4.9%	6.4%	0.0%	0.0%	0.0%
Network Appliance	10.03	26.84	13.98	92.00%	80.0%	65.0%	3.33	3.21	3.2	5.0%	6.0%	6.0%	0.0%	0.0%	0.0%
Novellus Systems	17.67	22.85	21.50	85.00%	85.0%	83.0%	3.1	3.3	3.3	3.1%	4.1%	6.2%	0.0%	0.0%	0.0%
Nvidia Corporation	28.09	23.94	13.02	88.00%	83.0%	85.0%	4	4	4	3.8%	4.3%	5.7%	0.0%	0.0%	0.0%
PerkinElmer	12.06	14.40	9.91	60.00%	50.0%	46.0%	4	4	3.7	3.7%	4.5%	6.5%	1.0%	1.0%	2.0%
PMC-Sierra, Inc	4.07	10.98	74.32	101.00%	90.0%	70.0%	2.1	3	3.1	2.6%	4.0%	6.1%	0.0%	0.0%	0.0%

S&P 500 Companies Options Information

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
QLogic	37 15	61 10	30 35	105 69%	98 5-136 6%	84 6%	5	5	5	5 4%	4 9-5 9%	5 9%	0 0%	0 0%	0 0%
Qualcomm	28 20	44 25	48 62	58 00%	63 0%	57 0%	6	6	5 5	4 4%	5 0%	6 3%	0 0%	0.0%	0.0%
Sanmina	6 00	22 46	19 51	95 00%	99 0%	67 0%	0 6+V	0 6+V	0 5-1 1+V	3 3%	5 0%	5 8%	0 0%	0 0%	0 0%
Scientific-Atlanta	14 30	22.67	22 71	76 00%	69 0%	61.0%	5	5	5	4 4%	5.3%	6 4%	$0.04	$ C4	3 5%
Solectron	6 97	17 91	15 92	70 00%	65 0%	52 0%	3	3 5	3 5	1 64%-4 14%	3 4%-6 34%	4 8%-6 8%	0 0%	0 0%	0 0%
Sun Microsystems	5 92	18 27	19.55	63.08%	61 4%	52 1%	6 8	5 8	5 8	4 5%	5 2%	6 0%	0 0%	0 0%	0 0%
Symbol Technologies	NYA	11 21	12 75	NYA	45 0%	43 0%	NYA	4	4	NYA	5 5%	5 5%	NYA	0 1%	0 1%
Tektronix	21 12	32.27	18 85	69 30%	65 8%	57 1%	4	3	3	4.4%	5 1%	6.3%	0.0%	0 0%	0.1%
Tellabs	4 31	16 85	33 88	72 20%	64 8%	62 6%	5 9	7	5 1	2 8%	4 9%	4 9%	0 0%	0 0%	0 0%
Teradyne	9 58	11.90	15 34	67.10%	67 0%	63.7%	4 3	4 3	4.2	3 4%	3 7%	5 7%	0 0%	0 0%	0.0%
Texas Instruments	13 48	10 72-23 32	21 01-30 5	56 00%	55 0%	51 0%	5	6	6	5 0%	5 2%	6 7%	0 3%	0 2%	0 2%
Thermo Electron	9 23	9 65	6 58	42 00%	45 0%	35.0%	6	5	3 9	4 2%	4.1%	4.9%	0 0%	0 0%	0 0%
Waters Corp	13 28	23 79	42 85	56 10%	56 5%	52 4%	7 5	7 5	7 5	3 3%	5 5%	5 4%	0 0%	0 0%	0 0%
Xerox	6 34	2 40	7 50	61 50%	51 4%	37 0%	6.5	6.5	7 1	4 8%	5 1%	6.7%	0.0%	2 7%	3 7%
Xilinx	19 22	37 91	18 87	76 00%	71 0%	65 0%	3 5	3 5	3 5	3 8%	5 9%	5 8%	0 0%	0 0%	0 0%
Telecommunication Services															
Alltel	14 19	16 98	18 59	29 70%	29 4%	26 0%	5	5	5	4 6%	5 0%	6 3%	2 5%	2 2%	2 0%
AT&T	24 49	39.50	60 50	40.00%	36 9%	33 5%	4.7	4 7	4.7	3 7%	4 6%	6 3%	1 2%	0 9%	1 6%
AT&T Wireless Services	5 57	7 56	14 43	65 00%	50 0%	55 0%	6	5	4	5 2%	4 2%	6 5%	0 0%	0 0%	0 0%
BellSouth	9 39	10 93	13.46	29 00%	26 0%	27 0%	5	5	5	4 0%	4 7%	6 3%	2 2%	1 8%	1 7%
CenturyTel	11 66	11 16	12 46	30 00%	30 0%	25 0%	7	7	7	3 4%	4 8%	5 3%	0 7%	0 6%	0 5%
Citizens Communication	4 98	6.00	6.31	44 00%	36 0%	30 0%	7	6	6	4 9%	5.1%	5 8%	0 0%	0.0%	0 0%
Nextel Communications	3 40	10 59	32 39	69-83%	59-69%	51 0-59 0%	3-5	3-5	3-5	2 5-5 1%	3 6-5 2%	4 9-6 9%	0 0%	0 0%	0 0%
Qwest	NYA	15 58	23 03	NYA	64 0%	52.6%	NYA	5 5	4 7	NYA	4 2%	6 0%	NYA	0 1%	1 0%
SBC Communications	6 57	8 37	8 31	23 00%	24 0%	16 0%	4 4	4	4 6	4 3%	4 5%	6 7%	3 0%	2 4%	2 2%
Sprint Corp Fon Group	3.47-4.05	7.11-8.78	23 86-24 24	35 20%	32.6-33.7%	26.6-26 7%	6	6	6	4 3%	4 9%	6 1-6 8%	3 5-3 9%	1 9-2.3%	0 8%
Sprint Corp Pcs Group	5 99-8 25	16 91-18 50	33 06-33 93	71 5-72 9%	74 3-75 4%	63 2-67 7%	6	6	6	4 3%	4 9%	6 1-6 8%	0 0%	0 0%	0 0%
Verizon Communications	12 ʻ1	15 24	13 09	28 50%	29 1%	27 5%	6	6	6	4 6%	4 8%	6 2%	3 2%	2 7%	3.3%
Transportation															
Burlington North Santa	7 84	8 44	6.70	35 00%	35 0%	36 0%	4	4	3	3 9%	4 2%	5 4%	$0 48	$0 48	$0 48
CSX	11 76	10 72	6 36	27 00%	27 0%	27 0%	6	6	6	4 3%	5 0%	6 6%	1 1%	2 3%	3 2%
Delta Air Lines	9 00	20.00	23.00	38 90%	26.9%	26 8%	6 7	7 5	7.9	4 4%	5.8%	6.0%	$0.10	$0 10	$0.10
FedEx	12 39	13 19	16 63	30 00%	35 0%	30 0%	2 5-5 5	2 5-5 5	2 5-9 5	2 9-4 9%	4 3-6 5%	5 6%-6 8%	0 0%	0 0%	0 0%
Norfolk Southern	8.26	5 48	5 22	32 00%	39 0%	33 0%	5	5	5	4 6%	5.1%	6 8%	0 0%	2 0%	3 0%
Ryder	7 52	5 69	5 01	29 60%	27 0%	26 9%	6	7	7	4 7%	4 9%	6 3%	2 7%	2 7%	3 5%
Southwest Airlines	3 54-8 52	5.69-9.11	4.47-9 79	34 00%	34.8%	34.8%	5	5-6	6	3 4%	4 5%	5.0%	0 1%	0 1%	0.1%
Union Pacific	17 78	13 09	11 84	28 80%	29 5%	31 4%	5	4	4	4 4%	4 3%	5 1%	1 3%	1 4%	1 6%
United Parcel Service	21 27	25.49	32 67	20 24%	32 4%	40 0%	5 00	5	5	4 7%	4 6%	6 3%	1 10%	1.1%	1.0%
Utilities															
AES Corp.	1 98	14 87	18.99	68.00%	86 0%	41 0%	9	8	7	3 8%	4 8%	6.4%	0 0%	0 0%	0 0%
Allegheny Energy	NYA	8 94	10 25	NYA	27 4%	28 7%	NYA	10	10	NYA	5 3%	6 5%	NYA	5 2%	5 5%
Ameren	NA	NA	NA	NA	NA	17.4%	NA	NA	10	NA	NA	6.8%	NA	NA	6.6%
American Electric Power	4 37-4 58	8 01	5 50	29 78%	28 4%	24 8%	7	7	7	3 5%	4 9%	5 0%	6 2%	6 1%	6 0%
Calpine	3 73-6 02	22 30	16 09	70 0-83 0%	76 0%	67 0%	4-9	7	7	2 39-3 83%	5.0%	6 7%	0 0%	0 0%	0 0%

S&P 500 Companies Options Information

Company	Wtd. Avg. Fair Value at Date of Grant 2002	2001	2000	Option Valuation Assumptions: Volatility 2002	Volatility 2001	Volatility 2000	Expected Life 2002	Expected Life 2001	Expected Life 2000	Interest Rate 2002	Interest Rate 2001	Interest Rate 2000	Dividend 2002	Dividend 2001	Dividend 2000
Center Point Energy	1.40	9.25	5.07	48.95%	31.9%	24.0%	5	5	5	2.8%	4.9%	6.6%	$0.64	$1.50	$1.50
Cinergy	4.95	5.42	2.75	26.45%	25.01-30.67%	20.2%	5.42	2.17-5.37	4.86	3.9%	4.22-4.78	6.6%	5.7%	5.26-5.42	7.3%
CMS Energy	1.44-3.84	6.43	2.04	32.44-40.81%	30.6%	27.3%	4.2	4.2	4.1	3.16-3.95%	4.8%	6.6%	$0.37-$0.18	$0.365	$.365
Consolidated Edison	6.37	5.23	4.42	21.43%	21.3%	20.5%	6	8	8	5.1%	5.2%	6.3%	5.2%	5.8%	6.6%
Constellation Energy	5.89-9.15	9.27	5.60	31.90%	41.3%	21.0%	5	5	10	4.45%	4.8%	6.4%	3.3%	1.8%	5.7%
Dominion Resources	10.91	11.70	6.86	22.67%	22.2%	21.5%	6	6	6	4.4%	5.2%	5.2%	4.2%	4.2%	5.2%
DTE Energy	6.25	8.81	5.19	19.79%	19.8%	18.5%	6	10	10	5.3%	5.4%	6.6%	4.9%	4.7%	6.5%
Duke Energy	10.00	10.00	10.00	29.90%	29.5%	25.1%	7	7	7	5.0%	5.0%	5.3%	3.4%	3.4%	3.7%
Dynegy	1.22	19.41	19.01	74.30%	46.4%	42.1%	10	10	10	4.2%	4.3%	6.1%	$0.15	$0.30	$0.30
Edison Int'l	7.88	3.88	5.63	18-54%	17-52%	17-46%	7-10	7-10	7-10	4.7-6.1%	4.7-6.1%	4.7-6.0%	1.8%	3.3%	4.5%
El Paso Energy	14.23	15.75	10.16	43.40%	26.6%	23.9%	6.95	7.25	7	3.2%	4.7%	5.0%	1.8%	3.0%	3.0%
Entergy	9.22	8.14	4.30	27.20%	26.3%	24.4%	5	5	5	4.2%	4.9%	6.6%	3.2%	3.4%	5.2%
Exelon	13.62	19.59	16.62	36.80%	36.8%	36.8%	5	5	5	4.6%	4.9%	5.9%	3.3%	3.2%	3.6%
FirstEnergy	6.45	4.97	2.86	23.31%	23.5%	21.8%	8.1	8.3	7.6	4.6%	4.7%	5.3%	4.4%	5.0%	6.7%
FPL Group	0.00	NA	39.64	19.18%	19.0%	20.3%	7	7	10	5.0%	5.0%	6.6%	4.0%	4.2%	3.8%
Keyspan	3.42	5.29	2.87	22.47%	29.0%	24.0%	10	10	6	4.9%	5.1%	5.5%	5.4%	4.9%	8.2%
Kinder Morgan	19.36	21.31	10.51	39.00%	34.0%	34.0%	6	6.5	4.5	4.0%	4.3%	5.0%	0.7%	0.4%	0.4%
Mirant	5.80	10.06	7.94	75.00%	49.5%	40.0%	5	5	6	4.3%	5.0%	6.7%	0.0%	0.0%	0.0%
Nicor	6.65	5.01	3.25	21.10%	23.5%	16.8%	4	4	3	4.7%	4.6%	6.4%	4.1%	5.4%	5.7%
NiSource	6.03	8.44	4.61	40.7-42.0%	27.5-28.4%	28.16-28.98%	5.8	5.6	5.4-5.8	4.4-5.1%	4.0-4.9%	6.06-6.60%	4.9-6.0%	3.58-4.90%	4.86%
Peoples Energy	4.84	3.69	4.01	24.73%	21.0%	18.2%	3	3	4	3.1%	5.9%	6.0%	6.2%	5.1%	6.0%
PG&E Corp.	6.61	5.80-6.01	3.26	30.00%	29.05%-33.00%	20.2%	10	10	10	4.7%	5.24%-5.95%	6.1%	0.0%	0%-4.35%	5.2%
Pinnacle West Capital	6.16	8.84	11.81	22.59%	27.7%	32.0%	5	5	5	4.2%	4.1%	5.8%	4.2%	3.7%	3.5%
PPL	11.68	10.42	3.35	39.11%	30.2%	19.8%	10	10	10	5.4%	5.5%	6.7%	3.3%	4.3%	5.7%
Progress Energy	6.83	8.05	NA	24.98%	26.5%	NA	10	10	NA	4.1%	4.8%	NA	5.2%	5.2%	NA
Public Service Ent.	4.37	7.22	8.73	30.24%	28.2%	26.6%	4	4.2	4.4	2.82%	4.4%	6.1%	6.84%	5.2%	4.9%
Sempra Energy	4.45	4.29	3.07	22.00%	24.0%	20.0%	6	6.00	6.00	4.8%	4.6%	6.8%	4.1%	4.3%	5.4%
Southern Co	3.37	2.82	3.36	26.30%	25.4%	20.9%	4.3	4.3	4	2.8%	4.8%	6.7%	$1.37	$1.34	$1.34
Teco Energy	27.97	NA	NA	25.92%	27.5%	22.9%	6	6	6	5.1%	4.9%	6.2%	5.5%	5.5%	5.2%
TXU	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Williams Companies	2.77	10.93	15.44	56.00%	35.0%	31.0%	5	5	5	3.6%	4.8%	6.5%	1.0%	1.9%	1.5%
Xcel Energy	NA	NA	NA	NA	18.0%	15.0%	NA	3-5	3-5	NA	3.8-4.8%	5.3-6.5%	NA	4.9-5.8%	5.4-7.5%

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WORKING PAPER

Corporate Governance, Executive Compensation, and Strategic Human Resource Management From 1992-2002
A Portrait Of What Took Place

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Introduction

As the future of executive compensation and corporate governancc is debated, it makes sense to do some comprehensive retrospective research on what took place over the last 11 years. This is the kind of study that was not easily doable because the Securities and Exchange Commission only required detailed reports on executive compensation in proxy statements after 1992. The database which is considered the gold standard on boards' of directors' decisions executive compensation, Standard & Poors Execucomp was created thereafter to make these data widely available to analysts, institutional investors, the media, and academic researchers. Only the passage of 11 years allows more comprehensive backward and forward examinations of the salient relationships between total shareholder return and various measures of executive compensation decided upon by corporate boards of directors. We conceive of this study as mainly a study of boards of directors decisions over the period about executive compensation and their impact on the firm.

The Study

This study examines the potentially 20,000 boards of directors' decisions that have created important executive compensation patterns in the economy for the entire population of the top 1500-2000 U.S. public companies from 1992-2002 using the entire universe of Standard & Poors Execucomp. (see Appendix I). It continues an earlier study of the relationship between boards' of directors decisions on the percent of all employee stock options granted to the top five executives as a group and total shareholder return. (Blasi, Kruse, and Bernstein 2003: 200-202; also reported in Morgenson 2002). In this current study, we explore the extent to which percentage increases in various types and formats of executive compensation made by boards of directors top to the CEO and the top five executives as individuals relate to future total shareholder return (TSR). The analysis is provided for CEOs separately and then, in some cases, for individual members of the top five executives reported to the SEC as separate individuals (with one exception noted below). We also explore the extent to which past or current total shareholder return predicts decisions which boards of directors made about these elements of executive compensation.

The authors caution that this study does not examine whether profit sharing or stock option grants or stock option profits for executives make any sense or whether executive pay should be aligned with the profits of shareholders. Obviously, an entire body of principal-agent theory strongly suggests that it does make sense that executives do well if shareholders do well. Moreover, one of the positive developments that took place since the classic owner-manager enterprises at the beginning of the last century passed to professional management was precisely to not pay these managers as bureaucrats (to refer to the theme of the Hall and Liebman study). Executives have important leadership responsibilities and deserve significant rewards when their companies use investors' funds wisely.

This study does not attempt to comment on or set the optimal size or scope of those rewards. That is a complex question which is now receiving the attention of a lot of theoreticians and practitioners and members of boards of directors. A new societal consensus on this matter would represent an important innovation on corporate affairs. The classic article on stock options by Hall and Liebman (1998) shows with a smaller sample several years ago (i.e. the period 1980-1994) that executives indeed do well when their company's total shareholder return performs better. They also proved that most of this reward came from stock option profits. As the authors of that study noted:

> ...we document a strong relationship between firm performance and CEO compensation. In addition, we show that both the level of CEO compensation and the sensitivity of compensation to firm performance have risen dramatically since 1980, largely because of increases in stock option grants (1998:653)

They also found that the level of CEO compensation and the responsiveness of CEO compensation to firm performance had also risen dramatically since an earlier study by Jensen and Murphy (1990). Murphy subsequently (1999) provided a comprehensive review of research on this and other important studies on executive compensation before 1999. Since then Core and Guay (2001) look at non-executive employee stock options in 756 firms from 1994-1997 and Mehran and Tracy (2001) have looked at the wider role of stock options in pay in the country.

This study -- while concerned to some extent with similar issues in some respects -- is focusing on a very different set of issues and one under current discussion in public policy debates about corporate governance involving corporations, shareholders, academics, politicians, and citizens in general:

a) Do increases in total shareholder return (TSR) in the current year meaningfully predict systematic boards of director actions on increasing the percent of the entire employee stock option pie or marginal increases in total executive compensation that is awarded to the CEO or other top five executives as individuals?

b) Do marginal percentage increases in the various types of executive compensation, particularly types of stock option compensation or executive profit sharing, predict future total shareholder return?

c) How should we think of these findings in light of how the entire "incentive" pie is divided among all employees?

d) What does this imply about how boards of directors have functioned in the past?

Questions a and b can be empirically tested. Questions c and d will be addressed in light of current corporate governance discussions in our interpretation of these empirical findings. Why do we think that this particular perspective on the problem and the historical data of executive compensation has merit? On one hand, it is our view that the current public debate has been overly influenced by an anti-corporate and anti-executive bias which somehow -- because of a combination of suspicion of corporate power or class jealousy or national politics -- seriously tries to imply that captains of industry do not deserve generous rewards in proportion to corporate performance. Any worker whose job depends partly on high quality corporate leadership realizes that not rewarding them well is obviously an imprudent policy. Surely, one does not want an economic system which, as Hall and Liebman earlier questioned, pays corporate leaders like bureaucrats, where their fate is divorced from the fate of shareholders and society, and employees, as a whole. On the other hand, the startling rise that has taken place in all forms of executive pay (Table 1 below) and stock option profits and paper wealth (Table 2 below) from 1992-2002 does lend itself to several other questions. Has the magnitude and rate of compensation increases for the executive group leading major U.S. corporations been related to sensible shareholder corporate governance? In the past, have proportional marginal increases in the percent of the incentive pie that boards allot to corporate executives properly drive future performance? Is there any evidence of some kind of "leap-frog" process taking place where the rate of the rewards are being bid up without an adequate explanation and a prudent judgement? In short, our focus is mainly on the range of issues dealing with the impact of boards of directors decisions related to marginal increases in executive compensation.

The Main Findings

Here is a brief summary of the main findings of the study relative to the key questions of inquiry:

a) Do increases in total shareholder return (TSR) in the current year meaningfully predict systematic boards of director actions on increasing the percent of the entire employee stock option pie or total compensation that is awarded to the CEO or other top five executives as individuals in the current year?

For stock options, the evidence indicates that on average boards of directors set up the executive compensation system for CEOs so that proportional increases in the percent of the entire company-wide employee stock option pie awarded to individual executives rewards increases in the current year total shareholder return. From 1992-2002 a large number of boards have used increases in the CEOs or the top five executives' share of the total employee stock option pie as a short-term perk related to improvement in TSR during that year.

For total compensation, (including salary, bonuses, Long-term Incentive Plans, the value of restricted stock, and EITHER the value of stock options granted or the value of stock option profits), it is also the case that when the company's total shareholder return goes up in any particular year that this <u>does</u> predict marginal increases in the percent of total compensation (with either stock option grant value included or stock option profits included). This is according to the basic idea of stock options that executives should do well when companies do well and that their interests should be aligned. This, however, is, as noted, not the main focus of this study.

b. Do <u>marginal</u> percentage increases in the various types of executive compensation, particularly types of stock option compensation or executive profit sharing, predict future total shareholder return?

The evidence indicates that proportional <u>marginal</u> increases in the percent of the annual stock option pie that goes to the CEO or top five executives as individuals do <u>not</u> systematically predict positive increases in total shareholder return in the next year, or average increases in total shareholder return in the next 3 years or the next 5 years. Neither do marginal increases in the Black-Scholes value of the options granted. Also, profit sharing as a percent of salary for the CEO and the top five executives does not predict future 1,3, and 5 year total shareholder return performance. (Since profit sharing is supposed to reward for past performance, this makes sense to us.)

The same general pattern holds for marginal increases in total executive compensation when either the value of stock option grants or the value of stock option profits is included. For CEOs and top five executives, marginal increases in total compensation (including the value of option grants or profits) do not predict future 1,3, and 5 year improvements in total shareholder return.

c) How should we think of these findings in light of how the entire "incentive" pie is divided among all employees?

Cash profit sharing for top executives in American corporations appears to be pervasive and very significant to executive wealth as it has been reduced to insignificance among other employees in the society in general. (Appendix III establishes this with an examination of executive profit sharing from 1992-2002.[1]) Equity compensation for top executives in American corporations, particularly in the form of stock options, is pervasive and very significant to executive wealth. This evidence suggests that profit sharing for executives is functioning as it was conceived, namely,

[1] For a comparative examination of profit sharing among workers in the entire population see the results of a 2002 survey of the entire work force by the General Social Survey that we carried out with Richard Freeman of Harvard University at http://www.rci.rutgers.edu/~blasi

as a short-term reward. However, marginal increases in the executives share of the total annual employee stock option pie are more often used as a perk for improved total shareholder return in that year (or even as a prod to improve performance when total shareholder return for that year has been sub-par.) Because there is no evidence that these marginal increases in the CEOs or the top five executives' share of the total employee stock option pie drive future 1, 3, and 5 year total shareholder return, this raises questions about whether boards of directors have been too focused on increases in the top executives share of the incentive pie. Since it is also true that marginal increases in total executive compensation (including the value of stock options granted or the value of stock option profits) do not appear to drive better 1,3, and 5 year total shareholder return, it would appear that this is evidence of some level of excess in executive stock options. Indeed, this phenomenon may have contributed to a "leap-frog" phenomenon in executive pay over the decade.

Not all companies this approach of concentrating options on the top. In a recent book (Blasi, Kruse, and Bernstein, 2004) and a new study (Blasi and Kruse 2004) we have examined companies that include broader ranges of non-executive employees in their stock option and profit sharing plans in the technology sector. While this study also documents evidence of some excess and corporate governance problems in this sector, it does demonstrate that an alternative approach has been used. Boards in other industries have also used broader-based stock option strategies.[2]

d) What does this imply about how boards of directors have functioned in the past?

The evidence presented here strongly suggests that boards of directors have been too focused on identifying and dividing up the incentive pie among the CEO and top executives when marginal grants of added incentive power to this group do not appear to drive future total shareholder returns. This study lends strong support to SEC Chairman Donaldson's push for the ability of shareholders to nominate some board members directly.[3]

We suggest that this can be partly a result of a bias introduced into the corporate governance process by a lack of true independence of directors, the reality that compensation consultants which they retain have had their attitudes and behaviors shaped in the past by collecting fees from just the same top managers and their staffs which they seek to consult about, and a long history of cultural attitudes which suggest that it is only or mainly people at the top who drive corporate performance.

This last view is entirely out of touch with the growing role of intellectual capital and team work in our increasingly knowledge-oriented corporation. and with academic evidence. While lack of evidence of the impact of marginal increases in certain components of executive compensation for the top five executives does not automatically imply that broadening these incentives out in any way would be better, this study does raise the issue of whether boards of directors have properly evaluated the strategic human resource management of all the firm's human capital and whether this kind of evaluation merits becoming a subject of board-level discussion. We will discuss these implications at the end of this article.

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[2] See http://www.rci.rutgers.edu/~blasi for a recent survey on broad option programs in the U.S.
[3] These proposals are summarized and discussed in a roundtable on Mr. Donaldson's proposals at the SEC web site, www.sec.gov, available at http://www.sec.gov/spotlight/dir-nominations.htm

The Context

There has been a startling increase in total executive compensation for the 7500 executives (the CEO and the next four executives making up the top five most important leaders of the firm) over the past decade. Table 1 (Executive Compensation: The Top Five Executives) below documents the rounded dollar values from Standard & Poors Execucomp. Total compensation for this group over the period according to Execucomp has been $177. Billion. The value of stock option profits and restricted stock grants have comprised almost $100. Billion of this $177. Billion. It becomes immediately apparent from examining this table, as Hall and Liebman (1998) observed for a period before the mid-nineties, the profits on stock including the central role of options, play a key role. (These scholars also looked at increases in the value of direct stock ownership which we do not examine in this study.) Having said this, after the significant market correction of 2000, there has clearly been a significant drop in total executive compensation and stock option profits, but not salary and bonus and the value of restricted stock grants. (Note however, in Appendix III that profit sharing by executives spiked after the market drop of March 2000 for some years.)

Table 2 below (Option Paper Wealth and Profits For The Top Five Execs of U.S. Corporations) firmly establishes that the promise of future stock option profits -- as a result of unexercised shares of the stock option pie which the executives were still holding -- insured continuation and perpetuation of this system of shared capitalism for America's executives.

Paper wealth from stock options represents an added multiple of 4-10 (i.e. 400%-1000%) of current year stock option profits in most years. Thus, by the end of 2002 after a significant market correction, paper wealth on all unexercised stock options can be estimated at $24.4 Billion which is a multiple of 4.6 of the $5.3. Billion of stock option profits in that year for the top five executives. Table 3 below (The March of Stock Options in the 1500-2000 Largest Public Companies) also establishes that the number of stock options granted to all employees has increased by a multiple of ten over the period and that the annual run rates of stock options granted annually have steadily increased over the period, although there has been a slowing in the last two years. Table 4 below (The Share Of All Employee Stock Options Going To The Top Five Executives of America's Corporations) shows that over this period five individuals have on average have received about 30% of the entire stock option package to all employees. As other scholars have also noted (Tracy and Mehran 2001), the average and median has gone down. While this is true, Table 5 below (Annual Stock Option Grants To U.S. Top Executives As A Percent of Total Shares Outstanding) demonstrates that boards of directors have actually significantly increased the run rate or the percent that annual grants of stock options to the CEO and the top five executives represent of total shares outstanding over the period. This last observation is an important one because the decline in stock options as a percent of total shares outstanding might lead to a corollary notion that top five executives reduced their own draw on total shares outstanding. That does not appear to be the case. (An additional part of the context is demographic evidence on who holds stock options, their occupational positions, income levels, and the degree to which broad-based option programs are common in the economy. This is not a focus of this paper but the authors have made recent data from collaborative research on this question available as noted above.)

Given the level, the growth, and overall societal size of these rewards, one can certainly make a case to examine their etiology far more systematically. Nevertheless, an element of skepticism must be introduced into any such analysis. During the same period the stock market expanded significantly. One must be careful yet again not to fall into the fallacy that says that executive wealth does not deserve to expand with improvements in the stock market and company performance. (Although some concerns have been raised, such as those by Hall and Liebman (1998) that executive pay might vary with an index to market-adjusted performance only.) One must also be careful to posit that there are appropriate civil, societal, and economic limits to incentives. We recently heard this second argument put succinctly for one Chairman and CEO who made $1. Billion in total compensation over the 1992-2002 period and whose shareholders initially made handsome profits and are now on hard times. The skeptical remark was this: "Did he really need the second $500. Million to do what he did?" Finally, if anyone was wondering whether there are special established interests that executives and current boards have a strong incentive to protect, one only has to consider what was (is) at stake for these 7500 persons as an institutional segment of American society to consider this question.

TABLE 1.
Executive Compensation: The Top Five Executives
In The 1500 Largest Corporations in the U.S. — Billions of $$

Salary	Bonus	LTIP	Restricted Stock Grants	Stock Option Profits	Other compensation	Total

1992	2.2	1.3	0.3	0.5	2.4	0.3	7.0
1993	2.7	1.8	0.3	0.6	2.4	0.6	8.4
1994	3	2.1	0.4	0.6	1.9	0.6	8.6
1995	3.3	2.4	0.6	0.8	2.7	0.7	10.5
1996	3.5	3	0.8	1.1	4.3	0.9	13.6
1997	3.7	3.3	0.9	1.5	6.8	1.2	17.4
1998	4	3.4	0.8	2.8	9.6	1.2	21.8
1999	4	3.9	0.9	1.9	10.7	1.4	22.8
2000	4	4.1	0.9	2.2	17.7	1.7	30.6
2001	3.8	3.3	0.6	1.9	9.2	1.4	20.2
2002	3.5	3.2	0.6	1.9	5.3	2.3	16.8
Sum	37.7	31.8	7.1	15.8	73	12.3	177.7

SUM 1992-2001 $177. Billion

Source: Douglas Kruse and Joseph Blasi, analysis of Standard & Poors Execucomp, 2002-2004.

Note: Numbers are rounded. 2001 numbers are based on approximately 25% of executives reporting only.

TABLE 2.
Option Paper Wealth and Profits For The Top Five Execs of U.S. Corporations

	# of cos.	# of execs.	Paper wealth by year: CEOs	Paper wealth by year: All top 5 execs	Profits on stock options exercised of top 5 execs
1992	1497	6193	$1,477,460,000	$6,710,039,000	$2,424,487,000
1993	1631	7836	$4,351,563,000	$11,500,890,000	$2,374,903,000
1994	1666	8429	$4,793,273,000	$10,850,253,000	$1,898,414,000
1995	1708	8668	$8,931,706,000	$20,418,621,000	$2,667,728,000
1996	1861	9274	$12,458,694,000	$28,953,579,000	$4,295,531,000
1997	1916	9520	$19,384,171,000	$45,054,953,000	$6,797,300,000
1998	1986	9922	$26,049,128,000	$57,466,666,000	$9,597,443,000
1999	1924	9850	$43,356,378,000	$92,995,005,000	$10,747,381,000
2000	1793	9454	$38,420,784,000	$79,208,106,000	$17,723,900,000
2001	1482	8699	$38,146,579,000	$61,688,898,000	$9,153,283,000
2002		8372	$11,931,356,000	$24,463,285,000	$5,282,023,000

Source: Douglas Kruse and Joseph Blasi, analysis of Standard & Poors Execucomp, 2002-2004.

Information is from company reports to the SEC.
Covers 1700 largest US corporations that are more than 95% of the stock market.

Notes:

Paper wealth is paper profit on all unexercised options if they were exercised.*
Profits are the reported profits on actual stock option exercises in that year to the SEC.

*This involves simply adding two values that each corporation reports to the SEC in its Proxy annually and are reported as variables in S&P Execucomp. They are: IN MONEY EXERCISABLE OPT or "the value of Exercisable In-the-Money Options. This represents the value the officer would have realized at year end if he had exercised all of his vested options that had an exercise price below the market price." and IN MONEY UNEXERCISABLE OPT or "the value of Unexercisable In-the-Money Options. This represents the value the officer would have realized at year end if he had exercised all of his unvested options that had an exercise price below the market price.

Table 3. March of Stock Options in the 1500-2000 Largest Public Companies*

Year	Annual Grants (actual #)*	Run Rates For All Companies*	Run Rates For the 500 500 Largest Companies*	Estimated Option Profits of All Options Exercised By All Employees** (from Desai 2002)
1992	843,187,000	1.03%	0.77%	$14. billion
1993	1,474,532,000	1.31%	0.94%	$15.3 billion
1994	1,509,664,000	1.33%	1.00%	$10.4 billion
1995	1,903,990,000	1.44%	1.22%	$17.6 billion
1996	2,710,167,000	1.89%	1.42%	$32.4 billion
1997	3,810,516,000	2.33%	1.59%	$42.6 billion
1998	4,915,995,000	2.82%	1.90%	$73.5 billion
1999	7,238,668,000	2.91%	2.74%	$74.8 billion
2000	9,305,324,000	3.13%	2.41%	$106.2 billion
2001	9,358,933,000	2.85%	2.43%	
2002	8,522,365,000	2.46%	1.86%	

Source: Douglas Kruse and Joseph Blasi, analysis of Standard & Poors Execucomp, 2002-2004.

*Figures computed from Execucomp by the authors.
**This is the average of the run rate for each individual company, however the figures do not exclude cancelled options, so this is typically called the annual burn rate of options.
***Computed by Desai (2002), Table 2, National Bureau of Economic Research. Note that these figures refer only to the 1500 largest public companies. Desai explains the computation of this column as follows: "Exercises for all employees are estimated by grossing up exercises of the top five executives by the average across all years of the median share of all exercises excepting that if the average is less than 1% then exercises are grossed up using 20%.

Table 4. Share of the Entire Stock Option Pie Granted To Top Five Executives.

MEDIAN MEAN

1992	23.7%	28.8%
1993	26.5%	31.4%
1994	28%	32.3%
1995	27.1%	31%
1996	26.9%	31.5%
1997	26.4%	31%
1998	24.7%	29%
1999	25.5%	29.1%
2000	23.3%	27.6%
2001	18.2%	23.4%

Average of means for all years: 29.51%

Source: Analysis of Execucomp by Douglas Kruse and Joseph Blasi, 2002-2004.

Table 5. Annual Stock Option Grants To U.S. Top Executives As A Percent of Total Shares Outstanding.

For the top 1500 corporations

	For The Chief Executive Officer		For The Top Five Executives	
	Mean	Median	Mean	Median
1992	.025%	0	.307%	0
1993	.126%	0	.404%	.091%
1994	.203%	.041%	.447%	.113%
1995	.185%	.043%	.442%	.00126%
1996	.220%	.049%	.595%	.199%
1997	.240%	.057%	.670%	.269%
1998	.279%	.077%	.779%	.360%
1999	.301%	.112%	.790%	.405%
2000	.322%	.138%	.813%	.427%
2001	.310%	.154%	.727%	.414%
2002	.283%	.143%	.656%	.389%

Note: All companies reporting are included even if they granted zero stock options.

Source: Analysis of Execucomp by Douglas Kruse and Joseph Blasi, Rutgers University, School of Management and Labor Relations, 2004

The Data

The data used for this study is the entire universe of Standard & Poors Execucomp from 1992-2002. Execucomp builds these files from company's proxy filings to the Securities and Exchange Commission and generally covers the largest 1500 companies filing with the SEC. Appendix I provides the actual number of companies that provide data for boards of directors decisions on the CEO and the top five executives. Rutgers University has a subscription to this dataset. Definitions and means and medians for the variables used in this study are shown in Tables 6 and 7 below.

Table 6. The Execucomp Data: Executive Compensation and Total Shareholder Returns.

Variable ($ figures in 000's)	Mean	Median	Standard Deviation	Minimum/Maximum
1)Salary	522	466	330	0/5294
2)Bonus	527	233	1368	2/102015
3)Long-Term Incentive Plan	132	0	788	-2361/31325
4)Stock Option Percent to Total	10.1	6.7	12.7	0/100
5)Stock Option Value Realized	1543	0	10270	-100/706077
6)TDC1 (Total Compensation)	3761	1556	11365	0/655448
7)TDC1 Percent Change (trimmed)* (includes value of options granted)	39.1	10.6	111.9	-87/811
8)TDC2 Percent Change (trimmed)* (includes value of options profits from options exercised)	56.0	11.6	158.1	-88/1318
9)Return To Shareholder 1 Year (trimmed)*	16.7	10.1	49.5	-79/299
10)Return To Shareholder 3 Year (trimmed)*	13.7	11.7	25.4	-53.0/111.5

11)Return To Shareholder 5 Year (trimmed)*	13.4	12.6	17.7	-36.8/76.3
12) Black-Scholes Value of Stock Options Issued				

Definition Variables:**

e) The salary is the dollar value of the base salary (cash and non-cash earned by the named executive officer during the fiscal year

f) The bonus is the dollar value of a bonus (cash and non-cash) earned by the named executive officer during the fiscal year

g) The Long Term Incentive Plan is the amount paid out to the executive under the company's long-term incentive plan. These plans measure company performance over a period of more than one year (generally three years).

h) The Stock Option Percent to Total is the percentage of the grant this' executive received relative to the total stock option pie granted to all employees in the fiscal year

i) The Stock Option Value Realized is the net value realized from exercising options, namely, the difference between the exercise price of the options and the market price of the company's stock on the date of exercise.

j) Total Compensation (TDC1) is comprised of Salary, Bonus, Other Annual Compensation, the Total Value of Restricted Stock Granted, the Total Value of Stock Options Granted (using Black-Scholes), Long-Term Incentive Payouts, and All Other Total.

k) TDC1 Percent Change is the year to year percentage change in TDC 1 which is comprised of Salary, Bonus, Other Annual Compensation, the Total Value of Restricted Stock Granted, the Total Value of Stock Options Granted (using Black-Scholes), Long-Term Incentive Payouts, and All Other Total.

l) The TDC2 Percent Change is the year to year percent change comprised of Salary, Bonus, Other Annual Compensation, the Total Value of Restricted Stock Granted, the Total Value of Stock Options Exercised (i.e. option profits net of exercise price), Long-Term Incentive Payouts, and All Other Total.

m) The Return To Shareholder 1 Year is the Total Shareholder Return including monthly reinvestment of dividends as computed by Standard & Poors and made available in the database for each corporation.

n) The Return To Shareholder 3 Year is the average Total Shareholder Return including monthly reinvestment of dividends as computed by Standard & Poors and made available in the database for each corporation.

o) The Return To Shareholder 5 Year is the average Total Shareholder Return including monthly reinvestment of dividends as computed by Standard & Poors and made available in the database for each corporation.

p) Black-Scholes Value of Stock Options Issued is the value of the option grant using the modified Black-Scholes method as computed by Standard & Poors and made available in the database for each corporation.

*Trimmed means that the top 1% and bottom 1% of values was trimmed in computing this in order to control for the effect of outliers.
**These descriptions are edited and expanded definitions of the variables made available by Standard & Poors Execucomp with the dataset.

In addition to these Execucomp variables we have derived a number of measures of executive compensation for the purpose of our analysis. They are listed in Table 7.

Table 7. Derived Variables On Executive Incentives.

	Mean	Median	Standard Deviation	Minimum/Maximum
1) The Annual Stock Option Share That The Top Five Executives As A Group Receive Of All Employee Stock Options Issued That Year	24.0	19.8	21.9	0/100
2)The Average Share That The Each Of The Top Five Executives Received Of All Employee Stock Options Issued In Any One Year				
CEO	10.1	6.7	12.7	0/100
Top Five as Individuals	4.794	3.96	4.38	0/100
3)Profit Sharing As A Percent of Salary for CEO (only bonus)	78.0	61.1	82.1	0/576.5

4)Profit Sharing As A Percent of Salary for CEO (bonus plus Long-Term Incentive Plan)	93.9	67.1	105.9	-145/715
5)Profit Sharing As A Percent of Salary for top 5 executives (only bonus)	63.4	50.2	63.3	0/574.6
6)Profit Sharing As A Percent of Salary for top 5 executives (bonus plus Long-Term Incentive Plan)	76.0	54.3	95.1	-38/3022

Definition of Variables

1) The Annual Stock Option Share That The Top Five Executives As A Group Receive Of All Employee Stock Options Issued That Year is the total percent of the entire employee stock option pie that the top five executives receive as a group.

2)The Average Annual Stock Option Share of the Top Five Executives is the percent of the total employee stock option pie granted to the top five executives as individuals, namely the average of the actual percents of the pie granted to each executive. For example, if in Corporation X five executives received 3%, 5%, 4%, 3%, and 5%, the average percent of the pie received would be 20%/5 or 5%.

3)Profit Sharing As A Percent of Salary (only bonus) is the bonus of the executive as a percent of the CEO's salary.

4)Profit Sharing As A Percent of Salary (bonus plus Long-Term Incentive Plan) is the bonus and Long-Term Incentive Plan payout of the executive as a percent of the CEO's salary.

5) Profit Sharing As A Percent of Salary (only bonus) is the bonus of the executive as a percent of the executive's salary for top five executives as individuals.

6) Profit Sharing As A Percent of Salary (bonus plus Long-Term Incentive Plan) is the bonus and Long-Term Incentive Plan payout of the executive as a percent of the executive's salary for top five executives as individuals.

Methodology

This analysis examines the within-firm change in total shareholder return as it relates to the within-firm change in marginal increases in a variety of executive compensation measures, such as the percent of the entire employee stock option pie granted by the board of directors to the CEO or a top five executive in any year or profit sharing as a proportion of salary for a top executive. This analysis is used for several additional measures of executive compensation. This analysis is based on fixed effects regressions with an AR1 correction for autocorrelation, with year dummy variables to control for general stock market movements in total shareholder return in any particular year. Both the upper and lower one percent of total shareholder return values have been trimmed to remove the undue influence of outlying values. By examining within-firm changes, this approach controls for any factors that remain constant in the firm over this period such as management quality, firm technology, product-market conditions and other influences upon firm performance. This approach does not control for a particular upward or downward movement in one year in an entire industry. In addition, in some specifications a no fixed effects OLS regression and a no fixed effects median regression is employed. All the regression results are provided in Appendix II (or the attached Excel file if this paper was available electronically). The analysis was conducted using STATA.

Total Shareholder Return and The CEOs & Top Five Executives Piece of The Stock Option Pie

Does the total shareholder return in the current year predict the percent of the entire employee stock option pie that boards of directors allotted to CEOs during that year?

Corporations have said that they introduced executive stock options to reward long-term shareholder return. One approach to studying this philosophy over the last eleven years is to analyze how short-term total shareholder return has influenced board of director decisions about marginal increases in the CEO's portion of the entire employee stock option pie. Specifically, what kinds of decisions have boards of directors made about their CEO's piece of the stock option pie during any particular year when total shareholder return went up during that year? The analysis begins by regressing the change in percent of all employee stock options awarded to the CEO during each year on the change in total shareholder return during that year. (This is adjusted for the change in Total Shareholder Return in the entire market as noted above.)

This analysis examines the stock option allocation in every year for every company in the entire universe of Standard & Poors Execucomp for the 1992-2002 period. In effect, we are analyzing potentially 16,500 boards of directors decisions (i.e., 11 years times about 1500 companies each with one CEO decision per year) In fact, over the period some corporations did not grant stock options to executives in a particular year or did not use stock options in their executive compensation systems at all. Thus, this analysis actually looks at 13,334 instances where stock options were used in the executive compensation system and where the board made a decision about changing the percent of the stock option pie that went to the CEO from one year to the next. The result of the analysis is that a one percent increase on this year's market-adjusted total shareholder return predicts a 0.011% increase in the percent of the total employee stock option pie awarded to the CEO in the current year. The finding is highly statistically significant.[4]

One question which a journalist or a stock market analyst or a compensation consultant might raise is: "How practically meaningful is this finding? Are you simply averaging the results of thousands of cases so that many companies do not actually behave in this manner? Are your results practically irrelevant or do the boards of directors of a lot of firms in the stock market actually behave like this?" This is a fair question. To answer it we explored precisely how many boards of directors actually did increase the percent of stock options awarded to the CEO in a particular year when the total shareholder return went up in that year, how many did not do that, and how many did nothing. We also looked at what the boards did when total shareholder return went down. The result of this exploration is that boards are clearly more likely to increase the CEO portion of the entire employee stock option pie when total shareholder return goes up than when it went down. Let's look at these findings in more detail.

As noted we looked at 13,334 board of director decisions. In 6,876 cases, the market-adjusted total shareholder return of the corporations went up in any particular year. We found that for all years, 42.9% of these boards did in fact take the step to increase the CEO's share of the stock option pie at some time during that year, 16.9% kept it the same, and 40.2% decreased it. Obviously, diverse behavior does exist in what boards of directors did, but more boards increased the CEO's share than did not and quite a large

[4] This is at the .001 level.

number did. So, it appears that the finding does have some practical significance and really does describe something that many real boards have actually done in the past. Our interpretation of this finding is that boards of directors quite commonly used an increase in the portion of the entire employee stock option pie to the CEO apparently as a reward for short-term total shareholder return in that year. This does not appear to be consistent with the stated purpose of executive stock options to reward long-term total shareholder return.

Next we focus only on the group of firms that had increases in market-adjusted total shareholder return in any particular year and dividing them into quartiles in order to see how each quartile actually dealt with the increases in the CEO's stock option slice of the pie during that year. This will provide more insight into the actual behavior of these companies and respond to any concern that we are reporting one average effect that has no practical implications. There were 2,947 instances where the market-adjusted total shareholder return went up in a particular year and the board of directors increased the portion of the total employee stock option pie that it awarded to the CEO. Table 8 below provides some descriptive statistics about the average and median increases in the CEO's share of the stock option pie that boards awarded in companies with various market-adjusted total shareholder returns.

Table 8 below illustrates that a significant number of boards of directors over the period chose to increase the CEO's portion of the entire employee stock option pie in the same year that total shareholder return went up. The fact that roughly the same phenomenon is observable in each quartile of market-adjusted total shareholder return performance with similar means and medians indicates that the general regression described above is not some statistical artifact but a reflection of actual behaviors.

Table 8. Corporations Where Market-Adjusted Total Shareholder Return Went Up and Boards Of Directors Increased The CEOs Portion of the Total Employee Stock Option Pie, 1992-2002.

Market Adjusted TSR Went Up By This Amount	The CEOs Share of The Total Employee Stock Option Pie Went Up By This Number Of Percentage Points At The:	
	Mean	Median
I. Above zero and below 14.64%	9.64%	4.31%
II. Above 14.64% and below 32.58%	9.49%	4.69%
III. Above 32.58% and below 62.55%	9.78%	4.86%
IV. Above 62.55%	11.85%	6.26%

Source: Analysis of the entire universe of Standard & Poors Execucomp by Douglas Kruse and Joseph Blasi of Rutgers University. This includes all cases of favorable total shareholder return in the year, for example, such as a change a –9% total shareholder return to a –8% total shareholder return. Note that there were 4272 instances of increased TSR, however in only 2,947 of these cases did the corporation use stock options, or award stock options in that year.

It is possible -- although we think (in the context of our understanding of how stock options are supposed to function) not persuasive given the stated mission of executive stock options -- to understand the case that a board of directors might make for an increases in the portion of the entire employee stock option pie awarded to the CEO as a perk or reward for same year increase in market-adjusted total shareholder return. Below we will address this issue in more detail by examining whether this had an impact on 1,3, and 5 year future total shareholder return. For now, we wish to look at the phenomenon of board increases of the CEO's share in more detail. It would however be much harder to understand that boards of directors would use increases in the portion of the entire employee stock option pie awarded to the CEO when market-adjusted total shareholder return in the same year went down. Oddly enough, this was a fairly common phenomenon also.

The finding that boards of directors tended to increase the stock option portion to the CEO when total shareholder return went up in the same year takes on importance when we consider that 39.6% of boards increased the CEO portion when the total shareholder return went down in the same year. Boards are clearly more likely to increase the CEO portion when total shareholder return went up than when it went down.

In 6,458 cases, the market-adjusted total shareholder return of the corporations went down in any particular year. We found that for all years, 39.6% of these boards did in fact take the step to increase the CEO's share of the stock option pie at some time during that year, 16.9% kept it the same, and 43.5% decreased it. Obviously, diverse behavior does exist in what boards of directors did and more boards decreased the CEO's share than did not but, in this second scenario, it is notable that quite a large number did. Our interpretation of this finding is that boards of directors quite commonly used an increase in the portion of the entire employee stock option pie to the CEO apparently to reward a CEO even when there was no short-term total shareholder return in that year. This does not appear to be consistent either with the stated purpose of executive stock options to reward long-term total shareholder return.

Why are increases in the portion of the entire employee stock option pie being rewarded to CEOs in years when they are doing a poor job? It is actually more difficult for us to see a cogent argument for this approach and it would seem not consistent with the interests of investors. It may be that some boards thought that more stock options would turn around poor total shareholder return in the future, so that the "dividing up" of the employee stock option pie was used as a short-term nudge to the CEO for future performance. However, in light of the stated mission of stock options in executive compensation, this makes even less sense than increasing the portion as a short-term perk.

More insight about this story can be gained by focusing only on the group of firms that had decreases in market-adjusted total shareholder return in any particular year and dividing them into quartiles in order to see how each quartile actually dealt with the increases in the CEO's stock option slice of the pie during that year. Table 9 below examines the 2,558 instances where market-adjusted total shareholder return went down over the 11 year period and the CEO was awarded a bigger piece of the entire employee stock option pie in that year.

Table 9. Corporations Where Market-Adjusted Total Shareholder Return Went Up and Boards Of Directors Increased The CEOs Portion of the Total Employee Stock Option Pie, 1992-2002.

Market Adjusted TSR Went Up By This Amount	The CEOs Share of The Total Employee Stock Option Pie Went Up By This Number Of Percentage Points At The:	
	Mean	Median
I Worse than -61.8%	9.51%	4.95%
II More than but not including -61.8% to -31.89%	9.65%	5.13%
III More than but not including -31.89% to -13.3%	9.43%	4.7%
IV More than but not including -13/3% to 0%	9.81%	4.9%

Source: Analysis of the entire universe of Standard & Poors Execucomp by Douglas Kruse and Joseph Blasi of Rutgers University. This includes all cases of favorable total shareholder return in the year, for example, such as a change a –9% total shareholder return to a –8% total shareholder return. Note that there were 3828 instances of decreased TSR, however in only 2,558 of these cases did the corporation use stock options, or award stock options in that year.

Thus, many boards of directors over the 1992-2002 period used marginal increases of the portion of the stock option pie awarded to the CEO both as a short-term perk or reward for total shareholder return during the current year and as a short-term nudge perhaps to increase total shareholder return in the future. We understand the logic that executives should make money on their previously granted stock options when shareholders are making money. (Although, as we write this some shareholder advocates and corporate leaders are calling to temper this view by requiring minimum holding periods for stock options to encourage a more long-term perspective.[5]) We have questions about the logic of increasing the CEO's share of the future incentive pie relative to all other employees when the company just because the company doing well in any particular year. These questions arise because stock options grants are not supposed to be used as a short-term perk or nudge. But when a board of

[5] For example, in a March 10, 2004 editorial page essay for The Wall Street Journal entitled "The Competitive Option," David Pottruck, the CEO of Charles Schwab & Company, said "a CEO should be required to hold at least 50% of his or her options for a minimum of 10 years (and perhaps this percentage should be even higher). This will reduce the CEO's motivation to manage earnings for short-term results simply to garner immediate personal financial gain from a quick exercise of the options. It also ensures CEO commitment to the company for the long-term." He also proposed that "stock options for a company's five most senior executives should not be exercisable for a minimum of three years. Upon receipt of stock options, each of these executives must select one of three sell strategies: (a) wait the three years and then sell in equal annual installments over the subsequent five years; (b) agree to sell the entire grant in a predesignated program after a minimum hold of five years; or (c) hold exercised or unexercised options until retirement or for a minimum of 10 years and then sell the underlying stock as they see fit. These approaches, similar to deferred compensation, require an upfront election, again reducing the motivation to manipulate the company's financial performance for personal benefit." He also proposed that the top five executives not receive more than 10% of the stock options in a company with more than 1000 employees.

directors increases the top five executives portion of the total employee stock option pie when Total Shareholder Return went down, this clearly does not make sense for investors.

Using the perspective of individual CEOs, it also explains several findings from a previous examination of the entire percentage of the stock option pie that went to the top five executives as a group by the co-authors of this article that compared firms not to themselves over time but to other firms. One finding of that previous examination was that a significant number of firms gave unusually high percentages of the stock option pie to the top five executives. Indeed, a quarter of firms gave above 41% of all employee options to the top five executives in certain years and some gave 50, 60.70. 80, even 90, and even 100% while others had boards which allowed them to repeat this behavior year after year. Another finding was that when the average percent of options given to the top five executives as a unit went up above a certain threshold -- the median of 29% - over the entire period (1992-2001), this was associated with average total shareholder return being lower over the period. (See Blasi, Kruse, and Bernstein, 2003:200-202. Reported in Morgenson 2002)

Both of these perspectives on the problem of executive compensation underline that there may be some usefulness of looking at the problem from the perspective of how the entire employee stock option pie is divided. Nevertheless, these findings raise other important issues. Do boards of directors really conceive of stock options as a long-term versus a short term reward. A review of the Executive Compensation Philosophy section of recent proxy filings to the SEC of the ten largest corporations in the country produces a clear picture of the stated goals of stock options (see Table 10)

Table 10. Executive Compensation Philosophies In Major Fortune 50 Companies Proxy Filings To The SEC.

Company #1. "EXECUTIVE COMPENSATION. COMPENSATION, NOMINATING AND GOVERNANCE COMMITTEE REPORT ON EXECUTIVE COMPENSATION. Compensation Philosophy: The Company's executive compensation program is designed to: (1) provide fair compensation to executives based on their performance and contributions to the Company; (2) provide incentives to attract and retain key executives; and (3) instill a long-term commitment to the Company and develop pride and a sense of Company ownership, all in a manner consistent with shareholders' interests....Equity Compensation: Stock options generally are granted annually under ___'s Stock Incentive Plan of 1998 to link executives' compensation to the long-term financial success of the Company, as measured by stock performance." Proxy of April 15, 2003.

Company #2. "REPORT OF THE EXECUTIVE COMPENSATION COMMITTEE.... Stock Options -- Stock options were also granted under the provisions of the 1997 Stock Incentive Plan. All executives are eligible to be considered for stock option grants. Options are granted to emphasize the importance of improving stock price performance and increasing stockholder value over the long-term and to encourage executives to own ___ Stock.... Options are granted based on competitive long-term incentive compensation practices. The size of these grants and other long-term awards is intended to place executives in the third quartile of long-term incentives granted at comparator companies. In determining the size of new grants to each Named Executive Officer, we consider the number of option shares each executive has previously been granted. Options are denominated in Common Stock. An additional option grant was made in February 2002 to executives in recognition of performance during 2001 in the areas of market share, quality, manufacturing productivity, and new products, and to motivate the leadership team to maintain the positive momentum going forward." Proxy of April 14, 2003.

Company #3. "COMPENSATION COMMITTEE REPORT. Long Term Incentives. The nature of the _______ business requires long-term, capital-intensive investments. These investments often take years to generate a return to shareholders. Accordingly, we grant incentive awards with a view toward long-term corporate performance. These awards may not fluctuate as much as year-to-year financial results. Long term incentive awards are intended to develop and retain strong management through share ownership and incentive awards that recognize future performance. Historically, _____ has used stock options as its primary long term incentive award. In 2002, restricted stock was used in place of stock options. The Committee concluded that, at this time, in this industry, and in this Company, restricted stock is more effective in aligning executives' interests with those of shareholders and in achieving the objective of retention... For senior executives, the restrictions on 50 percent of the shares are lifted in five years, and the remaining 50 percent are lifted after 10 years or retirement, whichever is later. See page 18 for more information on restricted stock. The number of restricted shares granted to executive officers is based on individual performance and level of responsibility. For this purpose, the Committee measures performance the same way as described above for short term awards. Restricted stock grants must be sufficient in size to provide a strong incentive for executives to work for long-term business interests and become significant owners of the business. The number of shares held by an executive is not a factor in determining subsequent grants." Proxy of April 17, 2003.

Company #4. "Executive Compensation Philosophy. Our key compensation goals are to hire, motivate, reward and retain executives who create long-term investor value. We use a variety of compensation elements to achieve these goals, including: "stock options and stock appreciation rights: we award these to provide incentives for superior long-term performance and to retain top executives because the awards are forfeited if the executive leaves before they become fully exercisable five years after grant;" Proxy of March 2, 2004

These excerpts have language similar to that in many proxy statements. They almost uniformly point to a clear philosophy of executive compensation that stock option awards are for future long-term performance. Other portions of the executive compensation philosophy of all the companies make clear that current year bonuses and multi-year cash and stock incentive plans are used to reward short-term behavior. This does not appear to be consistent with increasing the CEO's portion of all employee stock options in a year when total shareholder return goes up in that year. In most of the executive compensation philosophies that we examined was there any statement that the CEO's portion of all employee stock options would go up according to a philosophy that said that such an increase would be used to drive future performance in a year when total shareholder return was sub-par.

However, the issue of boards of directors decisions to increase the percent of the total employee stock option pie in a previous year was meant to drive total shareholder return over the long-term can be tested directly. Now, we will examine this issue of long-term performance more directly by looking at the impact of increasing the CEOs portion of the total employee stock option pie on future 1, 3, and 5 year total shareholder return. Perhaps, one can make a case at the board level that a marginal increase in stock options in a certain circumstance will drive better TSR. Now, we'll examine the results.

Do marginal percent increases of the entire employee stock option pie that boards of directors allotted to CEOs or the top five executives during any year predict total shareholder return in the next 1, 3, and 5 years?

In this case, the independent (predictor) variable is the percent of all employee stock options in a particular year awarded to the CEO or the top five executives and the dependent (predicted) variable is total shareholder return. The results are that each one percent increase in the annual percent of the total option pie that went to the CEO in the current year predicts no increase in TSR the next year, no increase in cumulative TSR over the next 3 years and no increase in cumulative TSR over the next 5 years.

In performing this regression in the case of the top five executives as individuals, we took the average of the percent of options given to each of the top five, so if CEO got 5% and next four top executives received 3%, 3%, 2%, and 2%, then the total percent of all employee stock options to the top five in that year would be 15% and the average per executive would be 15%/5 or 3%. The results are that each one percent increase in the average annual percent of the total option pie that went to each of the top five executives as individuals in the current year predicts a 0.05% increase in total shareholder return the next year. While there is a positive relationship to total shareholder return in the next year, there is no relationship to average total shareholder return over the next three or five years.

Thus, there is no meaningful evidence that increasing the marginal share of the stock option pie to either the CEO or top five executives systematically drove higher total shareholder return in the year after the grant, or drove average total shareholder return over the next three years or the next five years. Put differently, for top executives ramping up the proportion of stock options given to them relative to other employees within companies has been used more as a perk for current year total shareholder return than as a driver of future total shareholder return. The problem with this finding is that stock options for executives were supposed to hold out an incentive for future improvement in total shareholder return according to both the theory and to explicit statements by major corporations in their Securities and Exchange Commission filings.

This evidence does not test nor disprove that stock option grants play a role in aligning top executives with total shareholder value. What it questions and disproves however is whether increasing the pie going to them proportionally over the period made much sense and affected future total shareholder return performance. Stock options can still be a good incentive to align executive wealth opportunity with shareholder performance and it is good that executives make money when shareholders make money. The optimal executive compensation package is not an issue that this research addresses directly.

Total Shareholder Return and The Percent Increase In Total Compensation Of The CEO or the Top Five (Using The Value Of Stock Options Granted)

One question raised by these findings is the limitations of examining the portion of the entire employee stock option pie when Execucomp makes available information about the Black-Scholes value of actual stock option grants in any year. As Tables 1-4 above indicate, stock options make up most of executive compensation. Using the same methodology, the following analysis looks at whether marginal increases over the 1992-2002 period of total compensation from all sources for the CEO or the top five predicts total shareholder return in 1 year into the future or the average over the next 3 or 5 years. This total compensation measure includes the total value of stock options granted at Black-Scholes value plus salary, bonus/ltip, restricted stock value granted, other annual and all other as reported to the SEC.[6] The advantage of this variable is that we are looking at everything a board gave a top executive in a particular year. In this case we're examining the consequences of thousands of boards of directors actions over the last eleven years.

The result is that there is no evidence that marginal increases in the total compensation percent (with value of options granted) for the CEO or the top five systematically drove higher cumulative total shareholder return in the next year, or average total shareholder return over the next three years or the next five years. It just was not a significant driver of future total shareholder return.[7]

Specifically, our findings are that a one percent increase in the percent of total compensation (including Black-Scholes value of GRANTS) that went to the CEO in the current year predicts a -0.17% decrease in TSR in the next year, a -0.0067% decrease in average TSR over the next 3 years and a –0.0019% decrease in average TSR over the next 5 years (this is not statistically significant). A one percent increase in the percent of total compensation (including Black-Scholes value of GRANTS) that went to each of the top five executives in the current year predicts a -0.022% decrease in TSR over the next year, a –0.012% decrease in average TSR over the next 3 years, and an insignificant effect on average TSR over the

[6] The variable is called TDC1 in Execucomp and its annual increases is called TDC1 Percent Change.
[7] Regressions are available from the authors.

next five years. The negative relationship may reflect some regression to the mean in which TSR falls after an especially good year. However, what we think is most important in these findings is that we see no statistically significant evidence of positive increases in prospective TSR.

Remember, in the previous regressions, that we are focusing on the prospective impact of marginal increases. This does not mean that stock options did not align the fortunes of the executive with the fortunes of the firm looking back. Now we look at how current year performance affected rewards, in this case for the CEO alone.

For the entire universe of companies and years, we examined whether increases in the total shareholder return in any year predicted the percent change in total compensation in that year. There is a strong positive relationship that is highly statistically significant. When total shareholder return in a year goes up 1%, the total compensation percent (including value of options granted) goes up 0.284%.[8] Our interpretation of this finding is that it confirms once again that when companies do well, executives do well, in this case in terms of their total compensation as defined.

As noted, this does not mean that it is not important to compensate executives handsomely for excellent past corporate performance or to give them handsome incentives for the future. It does suggest that the LEVELS OF THE PERCENT INCREASES that took place did not necessarily drive future performance when looking into the past over this period.

[8] Note that the top and bottom 1% of values of TDC1 Percent Change were trimmed because of extreme values.

Total Shareholder Return and The Percent Increase In Total Compensation Of The CEO and the Top Five (Using The Value Of Stock Options Profits)

Another question raised by these findings whether the ultimate result of stock options granted to the CEO and the top five, namely, stock option profits, drove future total shareholder return. As Tables 1-4 above indicate, stock option profits make up most of executive compensation and they have also grown enormously. Using the same methodology, the following analysis looks at whether marginal increases over the 1992-2002 period of total compensation (now including stock option profits rather than grants) from all sources predicts total shareholder return in 1 year into the future or the average over the next 3 or 5 years. This alternative measure of total compensation measure includes the net value of stock options exercised (that is, the option profits net of the exercise price in the proxy) plus salary, bonus/ltip, restricted stock value granted, other annual and all other as reported to the SEC.[9] The advantage of this variable is that we are looking at everything that a CEO or the top five actually made from all sources as a result of previous boards of directors actions. In this case we're examining the consequences of thousands of boards of directors actions over the last eleven years.

The result is that there is no evidence that marginal increases in the total compensation percent (with value of options profits) systematically drove higher cumulative total shareholder return in the next year, or average

[9] The variable is called TDC2 in Execucomp and its annual increases is called TDC2 Percent Change.

total shareholder return over the next three years or the next five years. It just was not a significant driver of future total shareholder return.[10]

Specifically, the results showed that, on average, a one percent increase in the percent of total compensation (with stock option profits as the typical major component) that went to the CEO in the current year predicts a -0.019% decrease in TSR in the next year, a -0.01% decrease in cumulative TSR over the next 3 years and a –0.009% decrease in cumulative TSR over the next 5 years (this one not statistically significant).

On average, a one percent increase in the percent of total compensation (including stock option profits as a major component) that went to each of the top five executives in the current year predicts small negative decreases in TSR in the next year, the next 3 and 5 years or 0.059%, 0.028%, and 0.013%. The negative relationship may reflect some regression to the mean in which TSR falls after an especially good year. However, what we think is most important in these findings is that we see no statistically significant evidence of positive increases in prospective TSR.

Again, remember that with this previous analysis that we are focusing only on the <u>prospective</u> impact of marginal increases. This does not mean that stock options did not align the fortunes of the executive with the fortunes of the firm looking back. The next regression looks at the impact of current year TSR performance on current year total compensation percent (including the value of stock option profits) for the CEO only. For the entire universe of companies and years, we examined whether increases in the total shareholder return in any year predicted the percent change in total compensation in that year when option profits are added in. There is a strong positive relationship that is highly statistically significant. When total

[10] Regressions are available from the authors.

shareholder return in a year goes up 1%, the total compensation percent (including value of options profits) goes up 0.526%.[11] Our interpretation of this finding is that it confirms once again that when companies do well, executives do well, in this case in terms of their total compensation as defined, of which the major component is stock option profits.

As noted, this does not mean that it is not important to compensate executives for excellent past corporate performance or to give them significant incentives for the future. It does suggest that the LEVELS OF THE PERCENT INCREASES that took place did not necessarily drive future performance. Again, this particular research does not offer guidance on the optimal executive compensation package.

Total Shareholder Return and The Percent Increase In The Black-Scholes Value of Stock Options Granted To The CEO and the Top Five

One further question to explore is the impact of marginal increases in the Black-Scholes value of stock options granted to the CEO or the top five executives on prospective total shareholder return (TSR) in the next year, and the average of the next 3 and the next 5 years. This is an important refinement of the previous analyses for several reasons. One is that it regularizes the dollar value of all the company's options using a common technique (about which there has been some level of disagreement as a valuation technique for employee options). Another is that the measure actually looks at dollar values. Two executives may have had a 100% increase in total direct compensation (including the value of options granted)

[11] Note that the top and bottom 1% of values of TDC2 Percent Change were trimmed because of extreme values.

but for one the option granted part of this may have been worth \$1. Million, while for the other, it may have been worth \$100,000. So, the reason why this is salient is that a percent increase in the value of options granted as part of Total Compensation in one of the ten largest Fortune 500 companies may represent a very different kind of incentive than a percent increase in the value of options granted in a one of ten smallest Fortune 500 companies. This measure looks at each executive in the sample and analyzes the relationship between increases in the same dollar values of annual option grants and prospective shareholder return. To summarize, the results using three different regression approaches indicates that marginal increases in the Black-Scholes value of stock options offered this year do not predict current year, next year, or average 3 and 5 year prospective increases in total shareholder return. In fact, they predict small negative decreases in most of the specifications in most of the periods.

The first approach is a fixed effects regression with an AR1 correction that looks at the CEO and top executives within their own company. This allows us to address the problem that there may be that there are some executives in companies with high total shareholder return and some executives in companies with low total shareholder return. The results are that for CEOs in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a –0.0009 decrease in TSR in the current year (although this is not statistically significant), a –0.00036 decrease in TSR over the next year, a –0.00022 decrease in average TSR over the next three years, and a –0.00012 decrease in average TSR over the next five years, all of which are highly statistically significant.

For the top five executives, in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a –0.0009 decrease in TSR in the current year, a –0.00032 decrease in TSR over the next year, a –0.00015 decrease in average TSR over the next three years, and a –0.0008 decrease in average TSR over the next five years, all of which are highly statistically significant.

In a second approach, we also tested this relationship across the entire economy using the entire universe of Execucomp by comparing all companies to each other. This approach uses a no fixed effects OLS regression. The results are that for CEOs in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a +0.0006 increase in TSR in the current year (although this is not statistically significant), a –0.00017 decrease in TSR over the next year that is highly statistically significant, a –0.00011 decrease in average TSR over the next three years (statistically significant at the 0.01 level) , and a –0.0005 decrease in average TSR over the next five years that is highly statistically significant.

For the top five executives, in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a +0.0004 decrease in TSR in the current year (that is statistically insignificant) , a –0.00014 decrease in TSR over the next year that is highly statistically significant , a –0.0009 decrease in average TSR over the next three years that is highly statistically significant, and a +0.00001 increase in average TSR over the next five years that is statistically insignificant.

In a third approach, we also tested this relationship across the entire economy using the entire universe of Execucomp by comparing all companies to each other with a methodology that adjusted for outliers. Perhaps, it is possible that a few companies with high values were driving these results. This approach uses a median regression in the statistical program STATA to correct for this concern. This specification also controls for any general market movements.[12]

The results are that for CEOs in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a +0.0007 increase in TSR in the current year that is statistically significant at the 0.05 level), a –0.00022 decrease in TSR over the next year that is highly statistically significant, a –0.00017 decrease in average TSR over the next three years that is highly statistically significant, and a –0.00001 decrease in average TSR over the next five years that is not statistically significant.

For the top five executives, in the entire universe of Execucomp, a \$1,000. increase in the Black-Scholes value of options granted in the current year predicts a +0.0003 decrease in TSR in the current year (that is statistically insignificant) , a –0.00017 decrease in TSR over the next year that is highly statistically significant , a –0.00010 decrease in average TSR over the next three years that is highly statistically significant, and a 0.0000 increase in average TSR over the next five years that is statistically insignificant.

Executive Profit Sharing and Total Shareholder Return

[12] This is done using year dummies that are not shown in the regression table.

Another key way that companies align executives with capitalism is through profit sharing. This next section examines whether executive profit sharing serves as a reward for previous total shareholder return and whether it drives future total shareholder return. Executive profit sharing is fairly widespread among public corporations. As Table 2 indicates, Profit Sharing as a Percent of Salary for the top five executives averaged 78% over the 1992-2002 period (the median was 61%). When the value of Long-term Incentive Plan payments is included , Profit Sharing as a Percent of Salary for the top five executives averaged 93.9% over the 1992-2002 period (the median was 67.1%). Appendix III provides detailed information on executive profit sharing in the corporate economy.

The first analysis examined whether past total shareholder return in the last 1, 3, or 5 years predicted profit sharing as a percent of salary. The results are very positive and highly statistically significant. Indeed, executive profit sharing does seem to be working as planned. When shareholders have had past total shareholder return, boards of director frameworks have in general assured that executives get high profit sharing rates as a percent of their salary in the current year.

The average Bonus as a Percent of Salary over the period ranged from 80-110% of base salary per year over the entire 11 years. It crept up over the 1992-2002 period and was in fact highest after the stock market bust, 110% in 2000 and it did not go down a lot the year after the crash in 2001. Now going to total executive profit sharing, that is, cash Bonus + Long Term Incentive Plan payouts (some of which is paid in stock) as a percent of base salary, the average ranged from 64% to 84% over the entire 11 years including all executives. (This means not just figuring the average with only those executives who received profit sharing) and spiked at 87% in 2000 and did not go down markedly in 2001 at 74%. The median ranged from 51% to 69%. If one just examines the executives who received such profit sharing, the average ranged from 80-104% over the 11 years and it also spiked in 2000 at 100% but only went down to 87% in 2001. The median was at 57%-77% and it was also unusually high in 2000 at 70% and only went down the second year of the crash to 61%. (Appendix III)

Next we look at any impact of any current year executive profit sharing on the future total shareholder return. We examine whether marginal increases in executive profit sharing drove future 1, or average 3 and average 5 year total shareholder returns. For CEOs, on average, when Bonus as a percent of base salary went from 0-100% in the current year total shareholder return in the next year went down –7.3%, average TSR in the next 3 years went down 7.4%, and a verage TSR in the next 5 years went down -3.5%. For CEOs, on average, when Bonus+LTIP as a percent of base salary went from 0-100% in the current year total shareholder return in the next year went down –5.6%, average TSR in the next 3 years, went down –4.3% , and average TSR in the next 5 years it went down -3.5%.

For top five executives as individuals, on average, when Bonus as a percent of base salary went from 0-100% in the current year total shareholder return in the next year went down –10.8%,average TSR in the next 3 years went down -11%, and average TSR in the next 5 years went down –5.3%. On average, when Bonus+LTIP as a percent of base salary went from 0-100% in the current year total shareholder return in the next year went down –4.1%, average TSR in the next 3 years went down –3.9% , and average TSR in the next 5 years it went down –2.9%.

These predictions about the relationship between current year profit sharing and future total shareholder return do not surprise us. They underline the short-term nature of profit sharing which has traditionally had a strong look-back feature for executives. They also underline the importance of finding a forward-looking incentive that drives total shareholder return into the future.

Conclusion

Our interpretation of these findings is that they do not question the prudence of using stock options to resolve the principal-agent problem, but rather they question the ways in which boards of directors have made decisions about marginal increases in the stock option pie to top executives over this period. They raise principally questions of corporate governance. Taken together with the evidence of how executive stock option grants and profits have rapidly increased over this period and the evidence on how many boards of directors use increases in the stock option pie as a short-term perk under various scenarios, this further evidence on the zero impact that these marginal increases in the pie have on future total shareholder performance, lend credence to the argument that the corporate governance implications of executive compensation merit further examination. As noted, these findings provide a comprehensive examination of thousands of boards of directors decisions regarding executive compensation over the last 11 years and their effect on investors and shareholders. It is also possible that these results suggest a "leap-frog" phenomenon whereby executive compensation was bid up over the period without a clear justification for some of the marginal percentage increases.

One interpretation of these results is to blame top executives or to say that they should not have significant pay. However, we do not agree with this interpretation. First, executives play an important leadership role in the American economy and they do deserve to get pay increases if shareholders gain. Second, realistically, it is not clear that every board of directors understood the prospective impact of its decisions made in the past on total shareholder return into the future. Third, like any employee a top executive wants to be paid as much as they can for their job especially if they believe that there is evidence that they have done their job well or that their effort is at a high performance level. That is natural. It is not the institutional role of top executives to police their own behavior. That role falls to the boards of directors.

Boards of directors and those who design and regulate and monitor the country's corporate governance system need to take these results to heart. With this historical perspective, more care and objective analysis needs to go into the consideration of executive compensation going forward. These results have some powerful implications for corporate governance because they raise serious questions about the quality of many boards of directors decisions over this entire period.

What makes boards make marginal reward decisions for top executives that are not clearly tied to improving future total shareholder value? We think that the answer is a lack of independence and objectivity. They strongly suggest that many of the weak governance features of corporate boards over this period which could undermine independence and objectivity could certainly have played a role in this dysfunctional process. As such, the findings lend powerful support for the efforts of Secretary Donaldson of the U.S. Securities and Exchange Commission to allow more involvement of shareholders in board of director nominations.

One important point raised by these results is what should guide when CEOs and top executives should get marginal increases in their share of the stock option pie. It is a fair question but one for which these data and results do not have a detailed answer. As noted, the research does not offer a specific design for an optimal executive compensation package. Our general response is that the system of the last decade where boards often just laddled out more stock option grants to executives in the short-term when the company did well that year (presumably using one theory) or when the company did poorly that year (presumably using another theory) was not a good system. Also, the frameworks put in place allowed marginal increases in option grants and option profits that drove increases in total compensation, but apparently did not drive total shareholder return in many companies. Furthermore, the notion – as expressed in so many executive compensation sections of proxy filings – that a study of what other corporations have done -- as supplied by a compensation consultant -- somehow justifies what the board decides, is not acceptable in retrospect. More than a few observers have guessed whether many of these studies had a role in driving the leap frog phenomenon. We have not directly measured or studied the "leap-frog" phenomenon, but this study sheds some light on discussions about its possible existence.

The results also suggest that the oft-repeated notion that "there is a tight labor market for good executives" and their pay is what the market will bear, is an insufficient explanation. Why, for example, does the market bear marginal increases in the pay package that produce no marginal better results for shareholders? Again, our response is that this is a broken and imperfect market because the corporate governance mechanism that decides on the pay is not sufficiently independent and objective. In many cases, corporate governors at the top might were more oriented to using the corporate machinery to reward executives for short-term behavior rather than more carefully and judiciously aligning them with shareholders to drive future behavior. But the key piece of evidence is how any current year marginal endowments in executive compensation apparently made no significant difference for investors in the future. How boards of directors address this situation in the future is a major problem that they face. The evidence clearly suggests that maybe some of the largesse of <u>increases</u> in executive stock options -- as a percent of the total employee pie and in terms of the value of grants and profits -- were of no avail over the last 11 years. This fits with comparative studies that show that other Western and Asian countries apparently get by with less executive rewards than we do. (See Murphy and Conyon 2000).

It is important to digest the fact that the employee stock option pie is a pie that is divided by the board each year between top executives and all other employees. When top executives get marginal increases, other employees get less of the pie. These results relate to something we have been saying for some time: the research evidence indicates that on average broad-based stock option plans, employee ownership plans, and profit sharing plans are associated with future improvements in total shareholder return. (For a review of this evidence see, Blasi, Kruse and Bernstein, 2003:153-204; Sesil, Kroumova, Kruse, and Blasi,. 2000; Blasi, Kruse, Sesil, Kroumova, and Carberry, 2000; Sesil, Kroumova, Blasi, and Kruse. 2002; Ittner, Lambert and Larcker, 2001).[13] Why then have many boards of

[13] The results in this paper do not reflect the performance of broad-based plans since the Execucomp data do not report on the number of employees in any corporation who actually receive stock options in any year apart from the top five. A company could give a large or a small share of all employee stock options to the top five and then include just a small sliver of executives below them or up to the entire work force.

directors consistently focused marginal increases in their reward programs on the top of the corporation rather than on the rest of the corporation?

The answer we think is fourfold. First, that there has not been a solid awareness of the value of broad employee ownership. A gradual evolution of broad-based plans has been taking place in both technology and non-technology sectors of the economy that has not attracted as much attention as the headlines on executive pay. Some companies do take a different approach to dividing the incentive pie. (Whether their executives get too much or too little is a separate issue.)[14] Second, the executive compensation philosophy that the board adopts has been overly influenced by the self-interest of the CEO and the top executives who have more than a small amount of self-interest in persuading the board that "we are the group that affects total shareholder return" not these other less significant people. Using a national random sample of the entire US working population Freeman, Kruse, and Blasi (2004) have demonstrated that grants of profit sharing and broad-stock options does appear to change the behavior of mid-level and lower level managers, supervisors, and employees to impact the operations of the corporation. So this "we are the group" approach may have to be revised. Third, boards are not prominently involved in the strategic design of the company's work with its human resources, its reward systems and the corporate culture of the entire company. In effect, the boards are too "big man" and "big woman" focused on the human, intellectual, problem-solving, and social capital of the corporation. A recent book by Becker, Huselid, and Ulrich (2001) suggests how boards can do a

[14] For the whole economy the diffusion of these plans were measured in a recent survey designed by the authors with Richard Freeman of Harvard University at http://www.rci.rutgers.edu/~blasi For the computer

comprehensive strategic human resource management audit of human capital. These researchers found that the companies that significantly revised their corporation with a high performance workplace culture had better productivity and returns. Part of this story was a broader sharing of results documented in their empirical research. Fourth, if the board were to adopt a broad program of employee ownership and profit sharing, research evidence strongly suggests that it requires an ongoing attention to participatory management to make it work. Many top executives and many boards have been uncertain or unwilling to raise these questions as important strategic policy questions at that level of the company.

These findings combine with a contemporary development to create a serious quandry for boards of directors. At the end of March 2003, the Financial Accounting Standards Board called for the expensing of stock options on the income statement of corporations. Announcements by companies of changes in their stock option programs, surveys of their likely future behavior, and evidence from recent Securities and Exchange Commission findings have all confirmed that companies are and intend to reduce the number of employees who participate in their stock option programs and concentrate the percent of the entire employee stock option pie more at the top of the corporation. A recent issue brief provides a comprehensive summary and analysis of this evidence. (NCEO 2004). If as a response to expensing companies increase the percent of the annual stock option pie going to the CEO and the top five executives, the data in our study strongly suggest that this will be the absolutely wrong response and will work against rather than for corporate reform for investors and will in

technology sector we documented this in Blasi, Kruse, and Bernstein (2003) and for the biotechnolgoy sector we documented this in Blasi and Kruse (2004). See www.nceo.org for more on this sector.

fact not help total shareholder return. It would be ironic if, what is considered one of the most far-reaching reforms of executive compensation in decades, stock option expensing, were to have the opposite effect on corporate reform than it intended.[15] We have had serious reservations about the expensing of stock options for this reason. (Blasi, Bernstein, and Kruse chapter 10). We are floating the policy idea that would provide only companies with truly broad-based stock option programs a tax deduction or tax credit that would offset the stock option expense that FASB plans to require.

We recognize that just because marginal increases of shared capitalism for top executives may not lead to better investor returns, that it does not necessarily follow that marginal increases of shared capitalism for middle and lower level employees necessarily will in some automatic way. However, at the same time that this has been happening, there is a growing evidence that broad-based employee ownership and profit sharing can improve long-term corporate performance when combined with the proper corporate culture. Moreover, there is comprehensive evidence that the opposite of concentrating the top five employee stock option pie at the top does have implications for investor returns. As noted, corporations with significantly higher than average shares of all employee stock options going to the top five executives as a whole have had lower average total

[15] The authors intend to empirically measure the impact of FASB's decision on these questions by studying changes in the total percent of all employee stock options granted to the top five executives using two methods. First, we will use U.S. SEC filings to measure this proportion before the announcement of the FASB decision (between fiscal year 2002 and fiscal year 2003) – in expectation of the decision – and after the announcement of the FASB decision (between fiscal year 2003 and fiscal year 2004) after the Exposure Draft was announced. Second, we are also planning to collaborate with other scholars on conducting a nationwide random sample of the entire U.S. workforce on who is receiving and holding stock options, in 2006.

shareholder returns over the last decade (Blasi, Kruse, and Bernstein, 2003: 200-201; Morgenson 2001). The authors are collaborating with Professor Richard Freeman of Harvard University and others on a multi-year study of shared capitalism among different employee groups of corporations of various sizes and industries. This is funded by the Russell Sage Foundation and the Rockefeller Foundation at the National Bureau of Economic Research.

So what are the preliminary implications of these findings for the issue of shared capitalism in general? Our study suggests that boards of directors may have been paying too much attention to improving employee ownership and profit sharing for one group of its employees when it might make sense to focus on the role of broader employee ownership and profit sharing for a wider group of employees. Perhaps, broad employee ownership and profit sharing – within prudent limits with a participatory corporate culture that supports the incentive -- should be expanded and excessive emphasis on top executive compensation should be moderated. .

Most boards have designed a system of partnership capitalism for the top while ignoring the importance of independently assessing the role that broader use of profit sharing and employee ownership could play throughout the entire corporation. Shared capitalism should not be a system that boards of directors are willing to design only for the top executives sitting around the table with them. Boards need to start spending a lot more time on strategic human resource management. This means benchmarking their company with how leading firms divide the entire incentive pie more broadly and build a corporate culture to drive shareholder return. (for how to do this, see Becker, Huselid, and Ulrich 2001). If they can not do this then serious issues of independence start to arise.

Too many boards of directors think that only the top executives make a difference in the company's value, and the rest of the employees are just static factors of production like machinery. But a growing body of evidence shows that regular employees can really make a difference, and it's a mistake to exclude them from programs that reward good company performance.

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Appendix I. The Actual Number Of Corporations For Which Execucomp Data Was Available From 1992-2002.

Year	For The CEO	For The Top Five Executives
1992	425	1567
1993	1142	1676
1994	1534	1745
1995	1580	1847
1996	1616	1972
1997	1634	2030
1998	1693	2066
1999	1750	1943
2000	1735	1818
2001	1609	1692
2002	1569	1607

Total Potential Boards of Directors
Decisions Studied: 19,963

Source: Analysis of Execucomp by Douglas Kruse and Joseph Blasi, 2002-2004.

Appendix II. Co-efficients and t-statistics For Regressions.

This Appendix is attached in an Excel file in the electronic edition of this paper.

Appendix III. Profit Sharing For Chief Executive Officers.

	Only Those Who Got Profit Sharing	Including Those Who Got/Did Not Get It	Including Those Who Got/Did Not Get It
	Mean Bonus As A Percent OF Salary	Mean Bonus As A Percent of Salary (Median)	Bonus + LTIP As A Percent of Salary Mean (Median)
1992	81%	68%(62%)	89%(69%)
1993	80%	64%(51%)	79%(57%)
1994	85%	69%(56%)	80%(60%)
1995	90%	73%(58%)	80%(60%)
1996	97%	79%(62%)	97%(70%)
1997	100%	84%(69%)	104%(77%)
1998	101%	80%(63%)	98%(72%)
1999	106%	84%(67%)	101%(74%)
2000	111%	87%(66%)	100%(70%)
2001	103%	74%(55%)	87%(69%)
2002	110%	84%(62%)	99%(67%)

Source: Analysis of Execucomp entire universe by Douglas Kruse and Joseph Blasi, 2002-4

END

This is the Appendix to Corporate Governance, Executive Compensation, and Strategic Human Resource Management Fro

Appendix II. Coefficients and t-statistics For Regressions.

Each figure represents a coefficient (with t-statistics in parentheses) from a separate regression, using the dependent varia

Dependent variable:	Current year TSR			TSR in following year		
Type of regression:	OLS (1)	Median (2)	Fixed effects AR1 (3)	OLS (4)	Median (5)	Fixed effects AR1 (6)
Independent variables						
% Option Pie						
CEO	0.092	0.092	0.212	-0.030	-0.034	0.029
	(3.18)	(4.07)	(5.38)	(0.98)	(1.19)	(0.65)
TOP FIVE	0.017	0.023	0.104	-0.023	-0.016	0.050
	(1.05)	(1.66)	(4.59)	(1.33)	(1.22)	(2.06)
Option Profits as % of salary						
CEO	1.539	1.439	0.988	-0.202	-0.311	-1.160
	(16.16)	(17.25)	(8.09)	(1.99)	(3.41)	(8.69)
TOP FIVE	3.409	3.291	2.874	-0.751	-0.830	-3.627
	(24.93)	(26.96)	(14.90)	(5.22)	(6.55)	(17.60)
% change in Tot Comp1						
CEO	0.060	0.056	0.048	0.003	-0.002	-0.017
	(17.30)	(16.68)	(11.69)	(0.77)	(0.65)	(3.83)
TOP FIVE	0.091	0.082	0.084	0.007	0.002	-0.022
	(20.31)	(18.95)	(15.16)	(1.51)	(0.63)	(3.58)
% change in Tot Comp2						
CEO	0.054	0.052	0.043	-0.004	-0.006	-0.019
	(22.56)	(24.38)	(15.27)	(1.56)	(2.81)	(5.90)
TOP FIVE	0.137	0.128	0.128	-0.011	-0.018	-0.050
	(38.76)	(44.61)	(29.82)	(3.03)	(5.34)	(10.19)
Black Scholes value of SO grants						
CEO	-0.00006	0.00007	-0.00009	-0.00017	-0.00022	-0.00036
	(1.51)	(2.14)	(1.87)	(4.19)	(6.51)	(6.96)
TOP FIVE	0.00004	0.00003	-0.00009	-0.00014	-0.00017	-0.00032
	(1.83)	(1.60)	(3.06)	(5.76)	(8.95)	(10.53)
Bonus/Salary						
CEO	0.121	0.118	0.192	0.009	0.017	-0.073
	(27.24)	(30.70)	(27.08)	(1.77)	(3.47)	(8.68)
TOP FIVE	0.131	0.137	0.283	0.540	0.025	-0.108
	(24.02)	(26.57)	(28.43)	(0.91)	(5.32)	(9.39)
(Bonus+LTIP)/Salary						
CEO	0.077	0.075	0.119	0.004	0.014	-0.056
	(22.30)	(25.62)	(21.84)	(1.03)	(3.69)	(8.77)
TOP FIVE	0.060	0.078	0.101	0.001	0.014	-0.041
	(16.39)	(26.77)	(17.09)	(0.35)	(4.47)	(6.30)
% change in TCC						
CEO	0.210	0.217	0.205	-0.002	-0.070	-0.029
	(28.81)	(34.01)	(24.26)	(0.28)	(1.36)	(2.85)
TOP FIVE	0.315	0.296	0.307	0.007	-0.017	-0.026
	(30.32)	(32.62)	(26.01)	(0.65)	(1.67)	(1.87)

Coefficients are expressed as the percentage point increase in TSR for a one percentage point increase in the independen
Coefficients on Black Scholes value are expressed as the percentage point increase in TSR for a $1000 increase in the Bla
The upper and lower 1% of extreme values of TSR were trimmed for the OLS and fixed effects regressions.
The upper and lower 1% of extreme values were trimmed for the following variables: option profits as % of salary, % chang bonus/salary, (bonus+LTIP)/salary, and % change in TCC. The upper 1% of values were trimmed for Black Scholes value
Total Comp1 includes value of option grants. Total Comp 2 includes value of option profits.

om 1992-2002, A Portrait Of What Took Place.

ble at the top and controlling for year effects.

Average TSR in next 3 years			Average TSR in next 5 years		
OLS (7)	Median (8)	Fixed effects AR1 (9)	OLS (10)	Median (11)	Fixed effects AR1 (12)
-0.063	-0.031	-0.023	-0.094	-0.061	-0.009
(3.29)	(1.59)	(1.14)	(5.22)	(2.85)	(0.61)
-0.056	-0.031	-0.004	-0.064	-0.044	-0.007
(5.57)	(3.11)	(0.34)	(7.19)	(5.15)	(0.93)
-0.238	-0.225	-0.620	-0.059	-0.143	-0.300
(3.63)	(3.68)	(9.59)	(0.89)	(2.06)	(5.59)
-0.457	-0.473	-1.884	-0.032	-0.232	-1.148
(4.91)	(5.18)	(17.31)	(0.34)	(2.36)	(12.29)
-0.017	-0.003	-0.004	0.003	0.003	-0.002
(3.83)	(1.34)	(1.71)	(1.41)	(1.10)	(1.36)
-0.008	-0.011	-0.012	-0.001	-0.004	-0.003
(2.73)	(3.51)	(4.73)	(0.23)	(1.49)	(1.46)
-0.005	-0.004	-0.010	0.001	-0.001	-0.001
(2.99)	(2.67)	(7.52)	(0.58)	(0.69)	(0.86)
-0.011	-0.014	-0.028	-0.002	-0.004	-0.013
(4.34)	(5.37)	(12.93)	(0.89)	(1.33)	(7.14)
-0.00011	-0.00017	-0.00022	0.00005	-0.00001	-0.00012
(2.63)	(4.66)	(5.45)	(1.03)	(0.08)	(3.66)
-0.00009	-0.0001	-0.00015	0.00001	0	-0.00008
(4.52)	(5.59)	(6.84)	(0.20)	(0.11)	(3.98)
0.014	0.013	-0.074	0.019	0.010	-0.035
(4.39)	(4.54)	(16.00)	(6.28)	(3.23)	(9.28)
0.013	0.018	-0.110	0.023	0.017	-0.053
(3.64)	(5.36)	(17.82)	(6.78)	(5.11)	(10.61)
0.010	0.009	-0.043	0.012	0.008	-0.020
(4.12)	(4.07)	(13.08)	(5.47)	(4.16)	(8.22)
0.008	0.010	-0.039	0.015	0.013	-0.029
(3.50)	(4.76)	(11.57)	(6.48)	(5.22)	(9.62)
-0.021	-0.023	-0.049	0.001	-0.004	-0.015
(3.92)	(3.98)	(10.32)	(0.12)	(0.64)	(4.30)
-0.018	-0.023	-0.062	0.007	-0.002	-0.015
(2.42)	(3.04)	(9.86)	(0.92)	(0.21)	(3.13)

t variable, except for coefficients on Black Scholes value.
ack Scholes value of a stock option grant.

ge in Total comp1, % change in Total comp2,
e of option grants.

ROBERT H. HERZ
CHAIRMAN
FINANCIAL ACCOUNTING STANDARDS BOARD
RESPONSES TO
POST-HEARING QUESTIONS
SUBMITTED BY SENATOR JOSEPH I. LIEBERMAN

Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board

April 20, 2004

U.S. Senate Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget, and International Security

1. As you know, the Securities and Exchange Commission (SEC) has delegated to FASB the authority to set accounting standards. If someone wishes to challenge FASB's adoption of a final standard, what are the procedures for doing so? Can FASB standards – or the SEC acquiescence in them – be challenged in federal court? If so, on how many occasions have actions been brought in federal court challenging FASB standards? Please describe the outcome of each case.

We are not lawyers or legal experts, and fully and accurately responding to the question involves a legal analysis of the federal securities laws and the procedures of the United States ("US") Securities and Exchange Commission ("SEC" or "Commission"). It is our understanding, however, that public enterprises affected by Financial Accounting Standards Board ("FASB" or "Board") standards may obtain review of them through several available SEC procedures, which may then result in a right to judicial review.

We are unaware of any party pursuing any of the available SEC procedures to challenge an FASB standard and then seeking judicial review of the Commission's actions.

2. Under the Securities Act of 1933, the SEC retains the ultimate authority to set accounting standards and therefore can overrule or modify FASB standards. Since FASB's creation in 1973, in how many cases has the SEC overturned or modified a FASB-adopted accounting standard? Please describe each circumstance in which the SEC has done so.

As indicated in my testimony, for 30 years the SEC has looked to the FASB for leadership in establishing and improving financial accounting and reporting standards. As a result of the Sarbanes-Oxley Act of 2002 ("Act"), in April 2003, the SEC issued a Policy Statement reaffirming this longstanding relationship. The Policy Statement, consistent with the language and intent of the Act, reemphasizes the importance of the

FASB's independence to develop unbiased and credible standards of financial accounting and reporting for the benefit of the business and investment communities.

The Commission's willingness to look to the FASB for accounting standard setting and to support the FASB's independence always has been with the understanding that the Commission may exercise its authority to modify, supplement, or otherwise amend private-sector accounting standards. For example, the Commission maintains separate accounting rules relating to oil and gas accounting. It also requires various financial statement headings, footnote disclosures, and supplemental schedules and information not required by FASB standards. In addition, the Commission staff has on occasion provided interpretative advice on the application of FASB standards to specific facts and circumstances.

With respect to oil and gas accounting noted above, in 1977, the Board issued FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* ("Statement 19"), which required oil- and gas-producing companies to use the successful efforts method of accounting. Before Statement 19 became effective, the SEC issued ASR No. 253, *Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities* ("ASR 253"), which permits the use of either the successful efforts method or the full cost method of accounting for public enterprises. The SEC took that action because it believed that neither the full cost method nor the successful efforts method provided sufficient information on the financial results of oil and gas companies. In response to the SEC's actions, the Board issued FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies* ("Statement 25"). Statement 25 suspended the effective date of Statement 19's requirement to use the successful efforts method of accounting because, as a result of ASR 253, the requirement would have been imposed only on enterprises not subject to SEC reporting requirements and, therefore, the Board believed that the requirements of Statement 19 would not achieve comparability.

3. Is the "intrinsic value" method you mentioned in your testimony that is available to private companies the same "variable accounting" method that was used under APB 25? If not, please explain the differences.

As indicated in my testimony, the FASB's Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"), contained several decisions intended to mitigate the incremental costs nonpublic enterprises would incur in complying with the provisions of the Proposal. Those decisions included permitting most nonpublic enterprises (and other enterprises in limited circumstances) to measure equity-based compensation cost using an "intrinsic value method," rather than the fair-value-based method that would generally be required for other enterprises. Under the Proposal's intrinsic value method, the compensation cost for each reporting period would be measured based on the difference between any excess of the fair value of the enterprise's stock and the exercise price of the employee stock options granted. The final measurement of compensation cost would occur when the options are exercised, lapse, or are otherwise settled. The total amount of compensation expense reported under that method would generally be equivalent to the total amount of income tax deduction for option grants presently reported by those enterprises.

The intrinsic value method described in the Proposal differs from the intrinsic value method contained in APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"). Unlike the Proposal, Opinion 25 permits under certain special circumstances, compensation cost to be measured based on the difference between any excess of the fair value of the enterprise's stock and the exercise price of the employee stock options granted at the date of grant without any further measurement of compensation cost subsequent to that date. As a result, many enterprises have issued employee stock options with the quoted market price of the stock at the date of grant equal to the exercise price of the options and thereby avoided the reporting of any compensation expense for those valuable economic transactions. If, however, the special circumstances required by Opinion 25 are not met, the employee stock options are subject to the same "variable accounting" as required by the Proposal's intrinsic value method.

The Proposal's Notice for Recipients contained two specific issues soliciting comments on the intrinsic value method election. The Board received over 14,000 comments in response to the Proposal including many comments addressing those issues.

Following the issuance of the Proposal, the Board solicited additional input about the intrinsic value method election, including the costs of implementing and auditing that method, at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports. Those meetings and discussions included:

- A public meeting of the FASB's Small Business Advisory Committee
- Four public roundtables in which over 70 individuals participated
- Discussions with representatives of the FASB's Option Valuation Group and other valuation experts
- FASB staff interviews of users, auditors, and preparers of nonpublic financial reports
- A meeting with representatives of the venture capital industry.

The Board's public redeliberations of the Proposal include careful consideration of the extensive amount of input received in response to the Proposal. Those public redeliberations have resulted in many tentative improvements to the Proposal. Those improvements are described on the FASB's webpage at www.fasb.org.

The Board has yet to redeliberate at public meetings the Proposal's intrinsic value method election for nonpublic enterprises. Consistent with the FASB's Rules of Procedure, the input received on that issue will be carefully considered before the Board makes any final decisions. The Board's current plans are to complete its public redeliberations and issue a final standard by year-end.

4. Under the intrinsic value method set forth in the exposure draft, is the estimated value of the option adjusted for each reporting period?

See response to question 3.

5. If yes, does that mean that the value of any given grant of employee stock options could change every quarter or even more often if the company is required to issue financial statements more often? Would private companies be required under this method to estimate their stock price each time they are required to issue financial statements, even though, by definition, their stock does not trade?

As indicated in response to question 3, if a nonpublic enterprise elected to measure the cost of its employee stock options under the Proposal's intrinsic value method, the enterprise would be required to measure those options each reporting period that it issues financial statements prepared in accordance with generally accepted accounting principles ("GAAP"). Several factors are relevant in evaluating how often a nonpublic enterprise would be required to estimate the value of its stock under the Proposal's intrinsic value method election. Those factors include:

- The vast majority of nonpublic enterprises do not issue employee stock options.
- Many nonpublic enterprises do not issue GAAP financial statements.
- Many nonpublic enterprises that issue GAAP financial statements only issue those statements once a year.
- Existing GAAP requires that nonpublic enterprises estimate their stock price at the date of each grant of employee stock options.
- Existing US tax law requires that nonpublic enterprises that issue nonqualified employee stock options estimate their stock price at the date of each exercise of those options in order to measure and report the income tax deduction available for those options.

As indicated in response to question 3, the Board has yet to redeliberate at public meetings the Proposal's intrinsic value method election for nonpublic enterprises. Consistent with the FASB's Rules of Procedure, the input received on that issue will be carefully considered before the Board makes any final decisions.

6. Have you done any analysis of the additional cost that would be incurred by private companies of having to revalue their stock each time they are required to issue financial statements? If so, please provide us with all of the data you have gathered and any analysis you have completed.

Paragraph C70 of the Proposal states:

> The Board understands that relatively few small, nonpublic entities offer share options to their employees, and many of those that do are emerging entities that intend to make a future initial public offering. . . . Even under

> Opinion 25's grant-date intrinsic value method, an entity had to determine the intrinsic value of share options granted. If the entity granted options on a regular basis, it had to measure intrinsic value at the date of each grant. In addition, the variable accounting method required by Opinion 25 for certain share options was the same as the intrinsic value method required by this Statement. Moreover, the final measurement of compensation cost under the intrinsic value method in this Statement is the same as the measure of the related income tax deduction for nonqualified options under current U.S. tax law. Thus, the intrinsic value method in this Statement does not impose a significant additional computation cost on a nonpublic entity.

As indicated in response to question 3, the Proposal's Notice for Recipients contained two specific issues soliciting comments on the intrinsic value method election for nonpublic enterprises. The Board received many comments addressing those issues.

Also as indicated in response to question 3, following the issuance of the Proposal, the Board solicited additional input about the intrinsic value method election for nonpublic enterprises, including the costs of implementing and auditing that method, at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports.

Also as indicated in response to question 3, the Board has yet to redeliberate at public meetings the Proposal's intrinsic value method election for nonpublic enterprises. Consistent with the FASB's Rules of Procedure, the input received on that issue will be carefully considered before the Board makes any final decisions.

Minutes to the FASB's public Board meetings, minutes to the public meeting of the FASB's Small Business Advisory Committee, minutes of the public roundtables, public meeting handouts, comment letters, the comment letter analysis summary, the cost-benefit survey, and other information about the Board's project to improve the accounting for equity-based compensation, including various data, analysis, and other materials about the Proposal's intrinsic value method election for nonpublic enterprises, are publicly available on the FASB's webpage at www.fasb.org.

7. Have you done any analysis of the costs that auditors would charge to audit the expense if the intrinsic value method is used? Is so, please provide us with all of the data you have gathered and any analysis you have completed.

See response to question 6.

8. Please provide all memoranda, documents, and other written material indicating whether or not FASB Board members or staff believe that private companies would use the intrinsic value method set forth in the exposure draft.

Paragraph C74 of the Proposal describes the circumstances in which the Board believes that nonpublic enterprises would likely elect the intrinsic value method:

> The Board considered providing the same treatment as in [International Financial Reporting Standard 2, *Share-based Payment* ("IFRS 2")] IFRS 2 for share options granted by a nonpublic entity, that is, to require fair value unless it is not possible to reasonably estimate the fair value of the options at the grant date. . . . The Board notes that the end result of this Statement's requirements for nonpublic entities and the related requirements of IFRS 2 may be the same. Nonpublic entities that are able to develop a reasonable estimate of the fair value of their share options will avoid the need to remeasure the options at their current intrinsic value through exercise or other settlement. Nonpublic entities that cannot develop a reasonable estimate of fair value will use the intrinsic value method and remeasure their share options through the date of exercise or other settlement.

As indicated in response to question 6, information about the Board's project to improve the accounting for equity-based compensation, including various data, analysis, and other materials about the Proposal's intrinsic value method election for nonpublic enterprises, are publicly available on the FASB's webpage at www.fasb.org.

9. You have indicated that you have been told that many companies believe that they may be inclined to use the intrinsic value method or that they support the method. Please list all supporters and opponents, of whom FASB is aware, of using the intrinsic value method as proposed for private companies in the exposure draft. Please provide us with any communications you have received from or sent to non-FASB parties with respect to this issue.

As I stated in response to a question from the Honorable Senator Carl Levin at the hearing, there has not been much support for the Proposal's intrinsic value method election for nonpublic enterprises from the preparers of financial reports. I added that one reason for the lack of support was that many believe that the cost of employee stock options should be determined on the grant date "because that is the date that the deal is made. . . ." My assessment at the hearing of the views of preparers about the Proposal's election was later confirmed by many of the comment letters and other input the Board received on this issue.

As indicated in paragraph C72 of the Proposal, the intrinsic value method election for nonpublic enterprises was not selected by the Board based on how many enterprises would opt to make the election, but rather because the Board believed the election was "responsive to comments . . . that it would not be feasible for some nonpublic entities to estimate the fair value of their share options" and that the intrinsic value method election was superior to other alternatives.

As indicated in response to question 3, the Board has yet to redeliberate at public meetings the Proposal's intrinsic value method election for nonpublic enterprises. Consistent with the FASB's Rules of Procedure, the input received on that issue will be carefully considered before the Board makes any final decisions.

As indicated in response to question 6, information about the Board's project to improve the accounting for equity-based compensation, including data, analysis, and other materials about the Proposal's intrinsic value method election for nonpublic enterprises, are publicly available on the FASB's webpage at www.fasb.org.

10. Please explain FASB's rationale for expensing employee stock options at grant date, as opposed to vesting or exercise date?

In developing the Proposal, the Board concluded that grant date was the appropriate date for measuring the transaction because that is the date that the employer and employee come to a mutual understanding of the terms of the equity-based compensation award and that is when the employee begins to render the service necessary to earn the award. Measurement at that date appropriately bases the compensation cost stemming from the award on the stock price at the date the parties agree to its terms.

The Proposal's Notice for Recipients solicited comments on whether "grant date is the relevant measurement date." The Board received many comments addressing that issue. Most preparers of financial reports supported grant date as the appropriate measurement date for equity-based compensation as opposed to vesting or exercise date.

Following the issuance of the Proposal, the Board also solicited additional input on the Proposal's grant-date fair value measurement approach at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports. After carefully considering the extensive input received in response to the Proposal, the Board, at a public meeting, tentatively reaffirmed that the cost of employee services received in exchange for equity instruments issued by public enterprises should be measured based on the grant-date fair value of those instruments.

The Board's grant-date fair value measurement approach is consistent with long-established and generally accepted concepts and practices applied to other equity instruments. Under those concepts and practices, changes in the price of an issuer's stock after the parties agree to the terms of a transaction in which the equity instrument or award is issued generally do not affect the amount at which the transaction is recognized.

As explained by the Congressional Budget Office in their April 2004 paper *Accounting for Employee Stock Options*:

> The use of employee stock options effectively involves two types of transactions: the payment of compensation in the form of employee stock options (reflected on the income statement) and, when the options are exercised, a financing transaction (reflected on the balance sheet). That "hyrid" transaction requires recognizing the value of the options when they are granted as a cost on the income statement—but not any subsequent gains and losses in that value. [page 8]

The Board's grant-date fair value measurement approach also is generally consistent with the decision adopted by the FASB in 1995 in connection with the preferable accounting approach contained in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* ("Statement 123"). That approach has been applied by thousands of enterprises in reporting equity-based compensation amounts in their audited financial statement footnotes for eight years. Moreover, over 750 enterprises are currently using that approach in reporting their equity-based compensation expense in their audited and certified financial statements.

The Board's grant-date fair value measurement approach also is generally consistent with the approach adopted by the International Accounting Standards Board ("IASB") in 2004 in connection with IFRS 2. IFRS 2 will be adopted by companies in over 90 countries beginning on January 1, 2005. Those enterprises will join enterprises in Canada, which were required under the Canadian Accounting Standards Board's ("AcSC") *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870 ("Section 3870"), to begin expensing all equity-based compensation, generally consistent with the Board's approach, beginning in January of this year. We have been informed that there have been no significant concerns raised about the implementation of Section 3870 by Canadian enterprises, or by auditors or users of those enterprises' financial reports.

11. In FASB's view, do employees provide services in exchange for stock options at the time options are granted?

See response to question 10.

12. If FASB believes that options that do not vest should not be expensed, why has FASB not proposed expensing at vesting date as opposed to grant date?

In developing the Proposal, the Board concluded that compensation cost should be recognized only for those equity-based instruments that vest. That decision is intended to take into account the risk of forfeiture due to vesting conditions for purposes of estimating the grant-date fair value of equity-based instruments. Thus, under the Proposal, an enterprise is required to base its accruals of compensation cost on the number of instruments for which vesting is expected to occur and to adjust that estimate if the actual number of instruments is expected to differ from previous estimates.

The Proposal's Notice for Recipients solicited comments on whether "compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions." The Board received many comments addressing that issue. Most preparers of financial reports supported grant date as the appropriate measurement date for equity-based compensation as opposed to the vesting date.

As indicated in response to question 10, following the issuance of the Proposal, the Board also solicited additional input on the Proposal's grant-date fair value measurement approach at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports. After carefully considering the input received in response to the Proposal, the Board, at a public meeting, tentatively reaffirmed that compensation cost for an award of employee stock options or other equity instruments should reflect the number of instruments that actually vest.

The Board's grant-date fair value measurement approach is generally consistent with the existing accounting for restricted stock, cash bonuses, and other forms of compensation (other than fixed-plan employee stock options). That approach also is generally consistent with the preferable approach adopted by the FASB in connection with Statement 123. That approach has been applied by thousands of enterprises in reporting equity-based compensation amounts in their audited financial statement footnotes for eight years. Moreover, over 750 enterprises are using that approach in reporting their equity-based compensation expense in their audited and certified financial statements.

The Proposal's grant-date fair value measurement approach also is generally consistent with the approach adopted by the IASB for accounting for equity-based compensation that will be implemented by enterprises in over 90 countries beginning January 1, 2005. It also is generally consistent with the approach for accounting for equity-based compensation currently required and in use by enterprises in Canada.

13. Assume that one company grants two different employees (Employees A and B) stock options on January 1, 2004. The vesting date for all the options granted to both employees is December 31, 2008. Please further assume that Employee A leaves the company on December 29, 2008. Assume Employee B leaves the company on January 3, 2009. Under the exposure draft, would the accounting treatment of the options granted to Employees A and B be the same or different for each year? If different, please explain how.

As explained in response to question 12, the Proposal requires a grant-date fair value measurement approach in which compensation cost is recognized only for those equity-based instruments that vest. Thus, under the Proposal, an enterprise is required to base its accruals of compensation cost on the number of instruments for which vesting is expected to occur and to adjust that estimate if the actual number of instruments is expected to differ from previous estimates.

Under the Proposal's requirements, the total compensation expense for Employee A and Employee B would be different (the total compensation expense for Employee A would be zero) because Employee A forfeited the award prior to the vesting date.

As indicated in response to question 12, the accounting result for Employees A and B is generally consistent with the existing accounting for restricted stock, cash bonuses, and other forms of compensation (other than fixed-plan employee stock options). It also is generally consistent with the preferable accounting approach adopted by the FASB for equity-based compensation in connection with Statement 123. That approach has been applied by thousands of enterprises in reporting equity-based compensation amounts in their audited financial statement footnotes for eight years. Moreover, over 750 enterprises are using that approach in reporting their equity-based compensation expense in their audited and certified financial statements.

Also as indicated in response to question 12, the accounting result for Employees A and B is generally consistent with the approach adopted by the IASB for accounting for equity-based compensation that will be implemented by enterprises in over 90 countries beginning January 1, 2005. It also is generally consistent with the approach for accounting for equity-based compensation currently required and in use by enterprises in Canada.

14. Assume that a company granted 1,000,000 options on January 1, 2004, all with a four year cliff vesting, and that the Black-Scholes value of those options is estimated to be $100,000,000. Please further assume that 1,000,000 options never vest because all of the employees who received them leave the company's employ in late December 2007.

15. Does the exposure draft require companies to expense $25,000,000 in 2004, 2005, 2006, 2007?

As explained in response to question 12, the Proposal requires a grant-date fair value measurement approach in which compensation cost is recognized only for those equity-based instruments that vest. Thus, under the Proposal, an enterprise is required to base its accruals of compensation cost on the number of instruments for which vesting is expected to occur and to adjust that estimate if the actual number of instruments is expected to differ from previous estimates.

Under the Proposal's requirements, the total compensation cost for the company described in the question would be $25,000,000 each year in years 2004 to 2006. In year 2007, the company would have an adjustment to compensation cost of $75,000,000 because all of the employees who received the options forfeited the award prior to the vesting date. The hypothetical fact pattern described in the question, however, is unlikely to occur in actual transactions because it assumes that the company expected 100 percent of the options to vest at the date of grant and at each reporting period thereafter until late December 2007, and that 0 percent of the options actually vested.

As indicated in response to question 12, the accounting result for the company described in the question is consistent with the existing accounting for restricted stock, cash bonuses, and other forms of compensation (other than fixed-plan employee stock options). It also is generally consistent with the preferable accounting approach adopted by the FASB for equity-based compensation in connection with Statement 123. That approach has been applied by thousands of enterprises in reporting equity-based compensation amounts in their audited financial statement footnotes for eight years. Moreover, over 750 enterprises are using that approach in reporting their equity-based compensation expense in their audited and certified financial statements.

The accounting result for the company described in the question also is generally consistent with the approach adopted by the IASB for accounting for equity-based compensation that will be implemented by enterprises in over 90 countries beginning January 1, 2005. It also is generally consistent with the approach for accounting for equity-based compensation currently required and in use by enterprises in Canada.

16. Once it is determined that all the employees who received these options have left, does the exposure draft require companies to add back in $100,000,000 in earnings? Does the exposure draft effectively conclude that the $100,000,000 in estimated Black-Scholes expense was, in fact, not an expense?

See response to questions 14 and 15.

17. Have you done any analysis of the additional cost that would be incurred by private companies of having to use the fair value method as proposed in the Exposure Draft? Such costs would include, but not be limited to, software costs, costs of experts to determine the various inputs used in the lattice model, increased record-keeping costs, increased audit fees, increased internal staff hours, etc. and to revalue their stock each time they are required to issue financial statements? If so, please provide us with all of the data gathered and any analysis you have completed. If you have not done so, please explain why.

As described in paragraphs C42, C46, and C47 of the Proposal:

> Several procedures were conducted before the issuance of the Exposure Draft to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members and other valuation experts.

> Based on the findings of the cost-benefit procedures, the Board concluded that this Statement will sufficiently improve financial reporting to justify the costs it will impose. . . . .
>
> Several of the Board's decisions are intended to mitigate the incremental costs of complying with this Statement. For example, a nonpublic entity is not required to estimate the fair value of its share options; instead, such an entity may elect to account for its share options and similar instruments at intrinsic value, remeasured at each reporting date until settlement. Also, transition costs have been minimized by requiring that compensation cost for the unvested portion of awards granted before the issuance of this Statement be based on the grant-date fair values previously estimated for recognition or pro forma disclosure purposes under Statement 123.

As indicated in response to question 3, the Proposal's Notice for Recipients contained two specific issues soliciting comments on issues relating to nonpublic enterprises. Following the issuance of the Proposal, the Board solicited additional input on issues relating to nonpublic enterprises, including the costs of implementing the fair value method, at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports.

Also as indicated in response to question 3, the Board has yet to redeliberate at public meetings the Proposal's applicability to nonpublic enterprises. Consistent with the FASB's Rules of Procedure, the input received on that issue will be carefully considered before the Board makes any final decisions.

As indicated in response to question 6, information about the Board's project to improve the accounting for equity-based compensation, including various data, analysis, and other materials about the potential costs for nonpublic enterprises in applying the Proposal's fair value method, are publicly available on the FASB's webpage at www.fasb.org.

18. FASB's just released exposure draft urges companies to use a binomial, or so-called "lattice" model to value employee stock options, although companies would still be permitted to use the Black-Scholes method as well. It's my understanding that over the course of the last 9-10 years, nearly every public company in the US has used the Black-Scholes model in its footnotes or, for the very small number of companies who expensed, they, too, used Black-Scholes – is that correct? Put another way, between the time FASB adopted the current standard on stock options (FAS 123) and December 31, 2003, how many companies used a binomial method?

As indicated in response to question 10, the Proposal retains the same principle established in Statement 123 that a public enterprise should measure the cost of employee services received in exchange for awards of equity instruments based on the fair value of the instruments at the grant date. That principle encompasses several valuation techniques, including a lattice model (an example of which is the binomial model) and a closed-form model (an example of which is the Black-Scholes-Merton formula) with appropriate adjustments to reflect the unique features of employee stock options. In contrast to Statement 123, the Proposal indicated that a lattice model is preferable to a closed-form model because it can, by design, better capture the effects of the unique characteristics of employee stock options and similar instruments. The lattice model and the closed-form model, however, are based on the same well-established financial economic theory and with identical inputs will result in the same or substantially the same valuation.

The lattice and the closed-form models are routinely used by valuation professionals, dealers of derivative instruments, and others to estimate the fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities. Those models are also routinely used to establish fair market values for US tax purposes, and to establish values in adjudications. Finally, those models are used routinely by enterprises in estimating the fair value of financial instruments, including derivatives, and convertible bonds, and reporting those amounts in their audited and certified financial statements.

Although most enterprises have historically used a closed-form model in complying with the requirements of Statement 123 over the last eight years, over a dozen enterprises have used a lattice model. Hundreds of others have indicated that they are planning to adopt a lattice model. Those enterprises include some of the more than 750 enterprises that have voluntarily adopted expensing of all employee stock options in their audited and certified financial statements.

The Proposal's Notice for Recipients contained six issues soliciting comments on the measurement issues raised by the Proposal, including whether respondents agreed with the Board's conclusion "that a lattice model . . . is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments." The Board received many comments addressing those issues.

Following the issuance of the Proposal, the Board solicited additional input about the measurement issues raised by the Proposal, including issues relating to the lattice and closed-form models, at public and private meetings and in formal and informal discussions with many valuation and compensation experts and with many users, auditors, and preparers of public and nonpublic financial reports.

After carefully considering the input received in response to the Proposal, the Board, at a public meeting, tentatively decided to eliminate the explicit preference in the Proposal for the lattice model. That decision was based, in part, on the arguments made by some respondents that the Proposal's preferability designation was too prescriptive and might inhibit the continuing evolution of fair value measurement techniques.

19. Why has FASB refused to conduct field tests of actual valuation models with a cross industry sampling of companies?

As indicated in response to question 17, the Board conducted a field visit program with a broad range of enterprises and many other due process procedures in the development of the Proposal. As explained in paragraph C43 of the Proposal:

> The Board concluded that field visits were an appropriate means of gathering information about the perceived costs of the proposed changes to Statement 123. The Board noted that a field test was conducted before issuance of Statement 123 and that field tests are more important for standards that require new methods of accounting. That is not the situation with this Statement, which revises the fair-value-based method in Statement 123 rather than requiring an entirely new accounting method. Further, thousands of public entities have had several years of experience in developing fair value estimates for their share-based payment arrangements with employees—estimates that Statement 123 required for either recognition or pro forma disclosure purposes.

Examples of the other types of input, data, and evidence that the FASB considered in developing the Proposal's measurement guidance include:

- Results of discussions with a variety of parties including the Financial Accounting Standards Advisory Council, the User Advisory Council, and many other groups representing preparers of financial reports, and auditors, and investors, and other users of financial information.
- Results of discussions with many valuation experts and compensation consultants, including those on the FASB's Option Valuation Group.
- Results of surveys and discussions with equity-based compensation software providers.
- Information and views in the many comment letters received in response to the FASB's November 2002 Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment.
- Work done on this subject by other accounting standard setters, including the IASB and the AcSC.

As indicated in response to question 18, the Proposal's Notice for Recipients contained six issues soliciting comments on the measurement issues raised by the Proposal. The Board received many comments addressing those issues.

Following the issuance of the Proposal, the Board solicited additional input about the measurement issues raised by the Proposal at public and private meetings and in formal and informal discussions with many valuation experts and with many users, auditors, and preparers of financial reports.

After carefully considering the input received in response to the Proposal, the Board, at a public meeting, tentatively decided that the cost-benefit procedures that have been conducted by the Board provided a sufficient basis to conclude that the benefits from the improvements in financial accounting and reporting outweighed the related costs associated with the application of the Proposal's provisions, and that additional cost-benefit procedures, including additional field testing, was not warranted.

The Board's public redeliberations have resulted in many tentative improvements to the measurement approach contained in the Proposal. Those improvements are described on the FASB's webpage at www.fasb.org.

The Board has yet to complete its public redeliberations of the Proposal. Consistent with the FASB's Rules of Procedure, the input received on the Proposal will be carefully considered before the Board makes any final decisions. The Board's current plans are to complete its public redeliberations and issue a final standard by year-end.

20. To what extent is the FASB concerned that the proposed standard, if adopted as is, will lead to a situation where companies will use a binomial method and some will use Black-Scholes. Do you believe that investors find it more challenging to compare financial statements when different companies use different valuation models?

See response to question 18.

POST-HEARING QUESTIONS
SUBMITTED BY SENATOR JOSEPH I. LIEBERMAN

Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board

April 20, 2004

U.S. Senate Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget, and International Security

Questions for Chairman Volcker

1. What kind of feedback have you gotten about the IASB's process for considering divergent views?

2. It's my understanding that the IASB has received several requests that it re-expose its standard on employee stock options on the ground that a number of key issues were changed from the original proposal. Yet the Board has refused to re-expose. Why?

3. The European Commission has raised numerous, serious questions about the IASB's proposed standard on derivatives – to the point where the Commission refused to adopt the IASB's proposal. Is it correct that when the IASB proposes a standard, that is simply to beginning of a lengthy process of review at the technical, policy and political level?

4. Do you subscribe to the view that the European Commission – or Congress, for that matter – should stay out of the review process? Would you characterize the Commission's involvement as "political interference," as Chairman Herz and others seek to characterize congressional interest in the subject of stock options?

Responses of Paul A. Volcker to Questions of Senator Lieberman

Subcommittee on Financial Management, the Budget, and International Security
U.S. Senate Committee on Governmental Affairs

August 17, 2004

1) The Trustees of the IASC Foundation, who are responsible for oversight of the IASB, are not involved in the technical decision-making of the IASB. It is our responsibility, however, to assure that the IASB develops its standards through a fair and deliberate decision-making process.

Under our oversight, the IASB has established "due process" procedures similar to those of the Financial Accounting Standards Board (FASB). In the case of developing its standard on share-based payments, the IASB provided interested parties with several opportunities for comment on proposals. This process took over three years to complete, and the IASB:

- Before beginning its own work in 2001, asked for comment on a previously released paper, drafted jointly by the G4+1 group of national standard setters (Australia, Canada, New Zealand, the United Kingdom, and the United States) and the IASC, the IASB's predecessor. The IASB received 270 comment letters.
- Established an advisory group.
- Held a public roundtable, in New York, to discuss valuation methodologies
- Published an Exposure Draft, on which the IASB received 240 letters.

The IASB finally adopted its standard in February 2004. The IASB's decision-making process and the IASB's standard itself has not been nearly as controversial as that with respect to the proposed FASB standard.

In terms of formal feedback to the IASC Foundation Trustees, one organization did request a public hearing on valuation issues and called for the synchronization of project timetables with the FASB. Holding public hearings is one option available to the IASB in seeking public comment, but is not required under the procedures that the Trustees of the IASC Foundation and the IASB approved.

The IASB concluded that an additional round of hearings would not add much to what had been an intensive process. The Trustees were satisfied that the IASB followed a rigorous process. The IASB paid particular attention to the valuation issue that was raised as the proposed issue for discussion. As I alluded to above, the IASB regularly consulted with an expert advisory group, comprised of individuals from the investment, corporate, audit, academic, compensation consultancy, valuation and regulatory communities. The IASB received further assistance from other valuation experts at a public panel discussion held in New York in July 2002 and also followed deliberations at the FASB closely.

It is clear not all decisions of the IASB or the FASB will be universally popular. Experience has indicated that any decision related to share-based payments will engender criticism. At the end of the day, standard-setters must be able to make difficult and possibly controversial decisions. In this case, the Trustees of IASC Foundation are confident that the IASB worked to reach a well-reasoned solution to this complex problem.

2) Under the criteria that the IASB uses to determine the need for re-exposure of a proposed standard, the IASB determined changes made after the initial Exposure Draft were not so significant to require re-exposure. The IASB re-exposes issues for public comment only if they are recommending a significant change from the original Exposure Draft. In the final Standard, IASB did not change the three most important aspects of the Exposure Draft: 1) recognition of an expense would be mandatory; 2) fair value would be the basis of measurement of the expense; and 3) the value of shares or share options should be taken at grant date.

There were some changes made to the more technical aspects of the standard, but the IASB had already solicited comment on those issues. For example, IASB technical staff informs me that IASB changed its initial proposal to adopt the "modified" grant-date accounting methodology used in the US Standard, SFAS 123 *Accounting for Stock-Based Compensation*. The change was made in response to respondents' comments about the practicality of the units of service method. When the IASB issued its Exposure Draft, the IASB pointed out the differences between the two methods and asked for respondents' views on the different methodologies.

3) It is worth clarifying the status of the IASB's standard on financial instruments, IAS 39, and the position of the European Commission. The IASB's predecessor adopted IAS 39, and many companies, including large financial institutions in Europe, have used the standard since January 2000, the effective date for the standard. IAS 39 is similar to the US standard, SFAS 133.

When the IASB came into existence in 2001, it adopted all of the standards of its predecessor, including IAS 39. At the same time, the IASB recognized that the standard was complex and that implementation could be improved with some amendments and this began a discussion regarding the scope and substance of the improvements.

During this "improvements" process, initiated in 2001, the European Union decided to commit, in principle, to adopt the IASB's standards. However, consistent with the EU's legal requirements, the EU established a system for endorsement of the IASB's standards into European law. This process is separate from the IASB's due process, only applies to EU Member-States, and does not have a direct bearing on the accounting rules of other countries (now totaling nearly 70) requiring or permitting the use of international accounting standards.

The combination of the IASB's initiating its round of improvements and the EU's decision to adopt the IASB's standards clearly focused attention not only on the limited amendments being proposed on IAS 39, but on IAS 39 and the issue of fair value accounting more generally. Opposition to IAS 39's requirements has been strongest among some of the EU's financial institutions. Because the standards have to be formally approved by the European Commission for use in the EU beginning in 2005, those who object to elements of IAS 39, as "improved," have strongly urged the European Commission to withhold approval.

The IASB has worked closely with those in the banking community, the European Commission, and others to address these concerns, has made some technical amendments, and has provided explanatory materials and presentation clarifications. This has been done while maintaining the integrity of the principles involved. At the same time, the IASB recognized the need to bring closure to the debate so that there could be certainty before January 1, 2005, the European Union mandatory requirement date. For that reason, the IASB adopted its improved IAS 39 in March 2004. In response to the discussions, one limited proposed amendment on the so-called "fair value option" remains outstanding.

This has been an extraordinary effort to reach the widest degree of consensus possible consistent with the basic need for exposure of the value of financial instruments. There is no doubt that IAS 39 touches upon broader issues of the extent and practicality of fair value accounting for some businesses. Consequently, the IASB has emphasized its desire for intensive discussions with the affected parties on the underlying questions over the next year or two. In general, publication of an Exposure Draft is designed to elicit a process of comments as to the proposal's application, as well as any remaining questions of policy and principle. Given the process of consultation before the Exposure Draft, normally this comment period will be limited. One of the responsibilities of the Trustees is to insulate the IASB from political pressures.

Meanwhile, the IASB firmly believes that IAS 39 provides a workable transitional model, broadly converged with the United States and ready for adoption. The question before the European Commission is now whether it wishes to require the use of IAS 39, in whole or in part, by EU companies in 2005.

4) Before I respond directly to the questions, I would emphasize that my interest in accounting standard-setting and the reason behind my involvement with the IASB is my desire to have convergence of accounting standards internationally. As the world's capital markets integrate, the logic of a single set of accounting standards is evident. A single set of international standards will enhance comparability of financial information and should make the allocation of capital across more efficient. The development and acceptance of international standards should also reduce compliance costs for corporations and improve consistency in audit quality.

In response to your questions regarding "political interference", I would repeat what I said in my written testimony. Sheer political pressures in a national context will not, and cannot, lead to either consistency or quality. The net result of politicized national decisions would be to weaken, perhaps irreparably, one of the foundation stones of effective accounting practices in a rapidly globalizing world economy.

In both the United States and internationally, we have established systems that delegate the difficult decisions of accounting standards to a group of professionals, under the oversight of a representative body of Trustees committed to the public interest. As a Trustee of the IASC Foundation, it is the responsibility of my colleagues and me to ensure that the decision of the IASB is taken with due care, only after extensive consultation, and using the Board's best professional judgment.

This is a carefully conceived process. I recognize that both in the United States and in the European Union, there are lawful procedures by which the SEC or the European Commission is able to deny approval of a proposed standard. But to make accounting standards subject to raw political pressures in legislative bodies would, I believe, undercut all that is being achieved toward convergence in accounting standards around the world, a key ingredient of a well functioning system of international finance.

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August 5, 2004

Senator Joseph Lieberman
706 Hart Senate Office Building
Washington, DC 20510

Senator Lieberman,

I understand that you have some questions relating to my testimony at the Oversight Hearing on Expensing Stock Options. To the best of my ability, I have answered them below.

1. In a comment letter you submitted to FASB in January 2003, you endorsed putting the volatility input at zero when using an option pricing model to value employee stock options. Why do you believe that stock price volatility should be set at zero?

My January 2003 remarks to the FASB's "Invitation to Comment" have been taken completely out of context. At that time, I did not believe that stock price volatility should be set at zero *without concurrently using the full contractual life of the option in the valuation process.* That way, the full time value contained in the option given to the employee is being accounted for. This was a key component of what I proposed.

In that letter, I refer to recalculations of the option grant fair values for 236 companies in the S&P 500 in accordance with the suggested methodology. These were the companies in the index whose footnotes contained sufficient disclosures to permit recalculation. Note that 10% of the firms showed an *increase* in the fair value of their options versus the Black-Scholes method.

When faced with new information that contradicts a held belief, it is illogical to defend an incorrect belief. Since I wrote that letter, I have found that my proposed method has a flaw. A firm could manipulate the option value to always equal zero simply by issuing options bearing a strike price that increases each year at the same rate as the discount rate. My hope was to present a methodology that would eliminate such flawed results, but my January 2003 proposal was not robust enough.

Note also that I responded to the FASB's exposure draft, "Share-Based Payment" in June of this year, which was a draft of an actual standard and not simply an "invitation to comment." (An invitation to comment is an opportunity to trade ideas and thoughts on accounting matters; an exposure draft of a proposed standard matters much more when it comes to setting accounting standards. The former is tantamount to a theoretical brainstorming session; the latter is similar to drafting legislation that will have real effects.) In my June comment letter, I did *not* endorse the model I proposed in January 2003. Below, an excerpt from the letter which conveys my more current thinking about the FASB proposal:

> ***Universality.*** The standard must produce the same results for instruments that are of the same substance, and not provide reporting exemptions for certain stock based instruments that are equity instruments. I speak of the situation with fixed price stock options granted to employees, for which the related compensation has gone unrecorded by the vast majority of firms. An effective standard would require that these instruments be valued at the grant date and their expense be recorded as the employees earn the rights to the instruments. Instruments given to non-employees deserve the same treatment.
>
> ***Usefulness to users.*** Those who use financial statements have a certain burden upon them to be sophisticated enough in finance to understand just what it is that they're reading. While there are times that I would prefer to be a brain surgeon

instead of a financial analyst, I know that brain surgery is a difficult subject that cannot be "dumbed down" to a level that I might be able to grasp. So it is with stock-based compensation: by nature the compensation packages awarded are complex structures, and valuing them and recording them in the financial statements will not be as simple a transaction to report and discuss as would be, for instance, the purchase of goods for cash consideration...

I believe the FASB has fulfilled these criteria in its exposure draft. For the first time, companies will be universally required to account for employee stock options like the equity instruments that they are - and will merit the same kind of expense recognition as other equity instruments like restricted stock. This standard should go far toward improving the consistency and representational faithfulness of financial statements.

In a brainstorming session, I floated an idea that might improve financial reporting, and I later found it to be flawed. In drafting a real standard, I supported the FASB's plan as proposed.

2. What are the ramifications of not setting volatility at zero? What are the downsides, in other words, of requiring companies to estimate volatility?

I believe that there are no direct ramifications of "not setting volatility at zero." The only downside to having companies estimate volatility is that they might calculate - and rationalize - volatility inputs that are more favorable than others.

Does that mean the model presented by the FASB is unworkable? Absolutely not. Given sufficient information about the volatility estimate, market participants should be able to evaluate the reasonableness of such estimates and make their own judgments. I believe the current FASB proposal provides sufficient information.

3. Do you think stock price volatility is the most difficult thing to estimate when option pricing models are used?

In terms of the various inputs to option pricing models, stock price volatility takes the most effort to calculate, but it is not "difficult" to estimate. An undergraduate student, having completed Statistics 101, could calculate it with a spreadsheet and access to stock prices on Yahoo!

4. FASB has not agreed with your recommendation to set volatility at zero, correct?

I commend FASB for not agreeing with my January 2003 recommendation to set volatility at zero. As my June 2004 letter implies, I believe they have a better idea in their exposure draft.

5. Do you think they will reconsider their valuation approach during the comment period and adopt a final standard that allows for setting volatility at zero? Should they?

I do not think FASB will reconsider the valuation approach I suggested, nor should they. As I stated in my answer to question 1, I believe the approach I suggested can be manipulated to yield results (zero values) that do not represent anything close to an estimated fair value for option grants. Any approach that yields such a result should not be institutionalized in a standard, in my view.

6. If a company uses the Black-Scholes method or a binomial method, is it correct that they will be required to estimate volatility?

If a company uses the Black-Scholes or binomial method, they will be required to estimate volatility.

7. If, as you said in your January 2003 comment letter, that the "right" volatility input can be "whatever one wants it to be," how reliable do you think the stock option expense numbers will be if companies are required to use a pricing model that requires them to estimate volatility?

While companies certainly may manipulate volatility inputs to be "whatever one wants it to be," I believe that there are enough market participants who possess enough discriminatory ability to detect when gamesmanship has occurred if they are provided sufficient information about the inputs.

Companies have their reputation at stake when they publish financial statements; the disclosures surrounding the volatility estimates should provide market participants with the information to keep companies honest. If firms try to manipulate the volatility estimates, they'll risk losing their reputational capital. In the post-Enron era, reputational capital matters a great deal. Incidentally, Enron was a company where testimony by former executive Jeffrey Skilling indicates that his judgments were warped by the lack of investor visibility about stock options.

8. Do you think stock option expense estimates would be more correct using zero volatility, or more correct when companies are required, in every instance, to predict stock price volatility?

To quote John Maynard Keynes, I would rather be vaguely right than exactly wrong. Using a model where companies are required to estimate volatility in order to arrive at an estimate of option fair value corresponds to "vaguely right." Using a model where companies always employ zero volatility and can always arrive at a zero value for an estimate of options value is exactly wrong.

That said, I'd prefer a model that requires companies to estimate their volatility.

9. Let's assume a company issues 10,000 employee stock options today, and let's also assume that each of the options, for any number of reasons, is never exercised. Let's also assume that a new rule requiring the expensing of all options at grant date is into effect. Do you believe the company has incurred a cost for those 10,000 options? If so, what is the cost and how would you calculate it?

In a world where expensing of stock options is the rule, a company issuing options that are never exercised has still incurred a cost. The successful exercise of stock options is not what determines the cost to the *issuer*. The issuer receives services from employees in return for options; it's simply another form of remuneration. The options are equity instruments that have a value at the time of grant; they're a form of currency that employees accept for rendering their service. The company could issue them for payment of external goods or services, and their estimated value would be recorded. The same should be true for options granted to employees.

The fact that the options are not exercised simply means that the employees would have been better off had they been paid in cash.

10. How can it be that the company incurred a cost for those 10,000 options when they were granted? Did any cash leave the company? Was any employee ever able to buy anything with the options they received?

The company incurred a cost for those options when they were issued because they are a resource of the firm. They have a value, just like the options traded on exchanges every day - most of which go unexercised. The employees may not "buy anything with the options they received," but that's not what makes it an expense. To be an expense, cash does not have to leave a company. A simple example: a firm buys a machine that is used to produce books. The form of currency used to pay for the machine is a grant of non-tradeable options, and the estimated value of the options is recorded as the cost of the machine. Whether the machine-seller successfully exercises the options is not known to the purchaser, nor does it make a difference for the purchaser to record the economics of what has transpired; it knows it has spent resources to acquire a production input, and it has recorded that expenditure of resources.The machine is expected to produce books over the next three years and it is depreciated evenly over the next three years as it produces books. The depreciation expense is not a cash expense - but it is a component of the income stream related to the machine. The books are sold each year and the depreciation expense of the machine is matched against it. The management of the firm that made the machinery investment is not falsely lulled into believing that they are producing revenue out of thin air: the non-cash expense associated with the machinery makes them aware of the net costs of production. Note that no cash left the firm in either acquiring the machine or in depreciating the machine - and management knows their costs better than if they had ignored the cost of the machine because it paid for it with options.

To say that options granted to employees have no value denigrates the workers receiving them, for it is equivalent to saying that the value of their services is zero.

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I hope that my answers help you. If you have any other questions, don't hesitate to contact me. Best regards.

Sincerely,

Jack Ciesielski
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