GEORGETOWN UNIVERSITY LAW CENTER
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EQUITY COMPENSATION AFTER ENRON REFORMS

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Background

MANY DIFFERENT FORMS

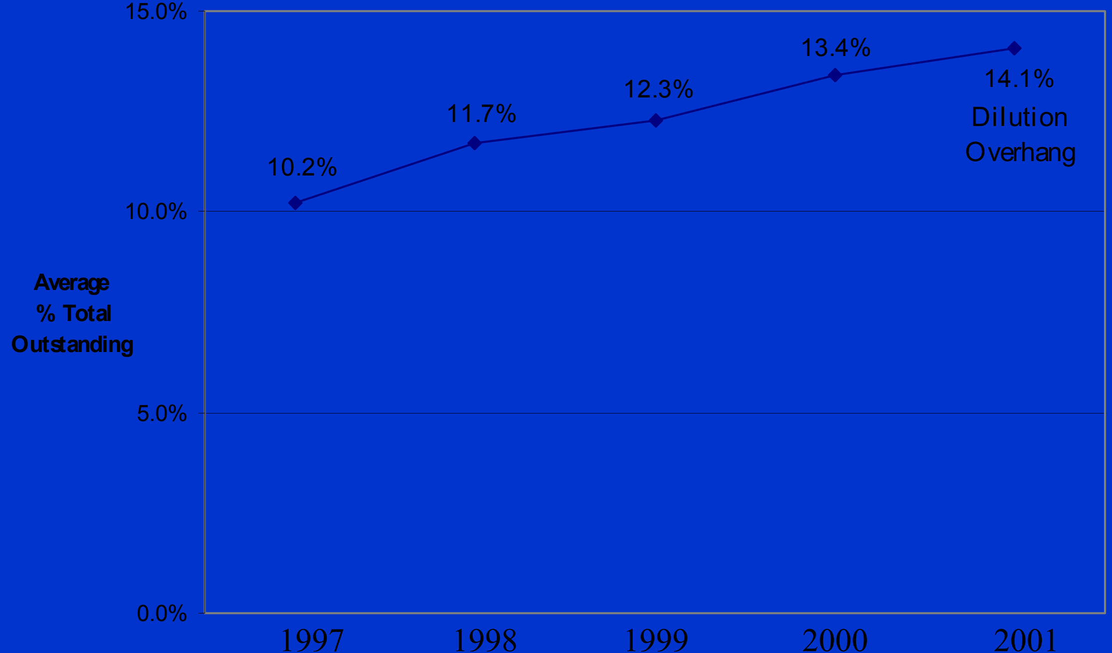
Equity compensation is not just stock options . . .

Long-Term Incentives	***Savings/Investment and Deferrals***	***Stock in Lieu of Cash***
Options	ESPPs	Outright Shares
SARs	401(k) Matching	Options
Restricted Stock	Voluntary Deferrals	Restricted Stock
Performance Stock	Mandatory Deferrals	
	ERISA Excess, SERPs	

Background

PRE-ENRON GROWTH

Dilution overhang from outstanding grants and shares increased steadily for years* . . .

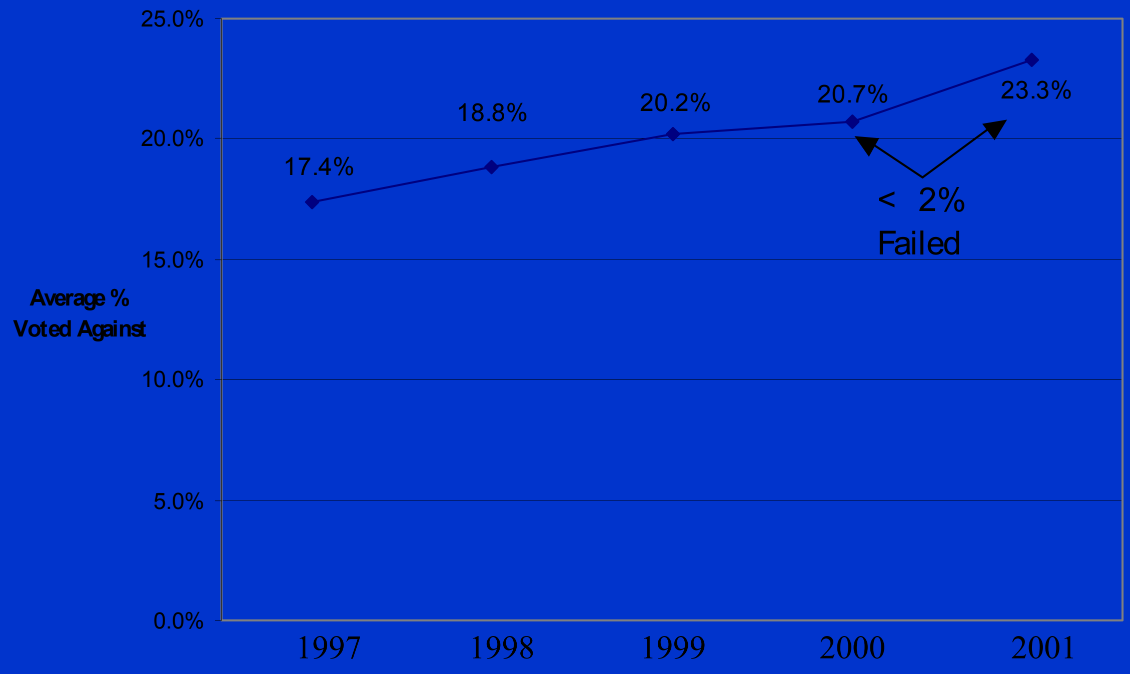


**IRRC data for S&P Super 1,500*

Background

PRE-ENRON SUPPORT

Investors encouraged the trend to align with shareholder-value creation strategies* . . .



**IRRC data for S&P Super 1,500*

POST-ENRON PERCEPTIONS

Public and investor attitudes turned negative, believing . . .

- **Large executive options encouraged excessive business risk and aggressive accounting to keep prices high**
- **Non-recourse and forgivable loans, option repricing, severance benefits, and SERPs eliminated personal risk for executives**
- **Executives used inside information to sell shares at high prices, while employees held shares and lost their savings**
- **Option accounting contributed to the speculative bubble in stocks by inflating earnings**
- **Cronyism and self-interest dominated the process for determining stock and other rewards**

Background

SWEEPING REFORM ACTIVITY

Aimed generally at improved corporate responsibility stronger accountability . . .

Regulatory	***Investor Activists***	***Best-Practice Initiatives***
Congress	CalPERS	BRT
SEC	TIAA-CREF	NACD
IRS	Vanguard	FEI
IASB/FASB	ISS	Conf. Board
NYSE/Nasdaq	CII	

Background

RELATED REFORM AREAS

Several reforms are specifically related to equity compensation . . .

NYSE/Nasdaq	***Sarbanes-Oxley***	***FASB***
Board compensation committee independence and written charters	Accelerated Form 4 filing for insiders	Quarterly disclosure of pro forma option expense
Shareholder approval of stock grants except new hires, and of option repricings	Prohibition on loans to officers and directors	Transition rules for those electing to expense
Elimination of discretionary broker voting		Bias toward future compulsory expense

TOPICS FOR DISCUSSION

Not a detailed description of the various reforms . . .

- **Update on major open reform issues *(Where do things stand?)***
- **Immediate and expected impact on program design and administration *(What are the implications?)***
- **Planning ideas to be proactive *(How should we respond?)***

Update

LOAN PROVISIONS

Typical questions of scope and intent . . .

Current Status	*Next Steps*	*Likely Timing*
Uncertainty if rules apply to cashless option exercises, split-dollar insurance, contingent signing bonuses, qualified plan loans, etc.	Regulations needed to clarify	No work currently underway, and no indication of when it will begin

Update

SHAREHOLDER APPROVAL

Ball is in the SEC's court . . .

Current Status	***Next Steps***	***Likely Timing***
Proposed rules were approved for SEC review by NYSE and Nasdaq Scope/intent fairly clear, although some questions about grandfather provisions	SEC will issue proposed rules followed by a public comment period and adoption	Proposed rules are already late Timing cut-off for adopting final rules is Spring-2003 proxy season

Update

OPTION ACCOUNTING

Much more complicated and politicized than other areas, and more at stake . . .

- **Hardest to predict outcome**
- **3 distinct activities to watch**
  - **-- FASB**
  - **-- IASB exposure draft**
  - **-- Option valuation methodologies**

Accounting Chronology…

October 4, 2002	FASB releases Exposure Draft that eventually becomes Statement 148 (issued December 31, 2002)
November 4, 2002	Comment period for FASB Exposure Draft ends
November 7, 2002	IASB releases Exposure Draft on Share-based Payment
November 18, 2002	FASB releases Invitation to Comment on Share-based Payment and Statement 123
December 15, 2002	Statement 148 effective for fiscal years <u>ending</u> after this date (i.e., calendar year 2002 financial statements) Statement 148 effective for quarterly reports <u>beginning</u> after this date (i.e., first quarter 2003 interim reports for calendar year companies)
February 1, 2003	Comment period for FASB Invitation to Comment ends

Accounting Chronology (cont'd)…

March 7, 2003	Comment period for IASB Exposure Draft ends
March 31, 2003	FASB plans to make decision by end of first quarter whether to reconsider accounting for stock compensation (beginning of the end for Opinion 25)
January 1, 2004	Proposed effective date for IASB's International Financial Reporting Standard (IFRS) on Share-based Payment
January 1, 2005	European Union (EU) to require companies listed on European stock exchanges to switch to IASB standards (2007 for companies also listed in the U.S.)
?	Effective date for possible FASB mandate to expense stock options; 2004 may be overly ambitious (despite the FASB's "fast track" to change) given the complexity of issues to be resolved

Update

OPTION VALUATION

General consensus, even among option-expense advocates, that Black-Scholes values are too high for expense calculation . . .

Current Status	*Next Steps*	*Likely Timing*
Financial service companies are studying market-based models; the BRT and FEI have named task forces to study issue	Results will become known as they develop	No schedule but progress expected shortly

Implications

BLACK-SCHOLES ASSUMPTIONS

We must all become better informed quickly . . .

Pfizer base case option @ $33 on 9/1/02, 5 year term, 5 year monthly volatility/yield, and 5 year STRIP interest-rate

		+/- Base Case		
	Option Value per Share	***per Share***	***Total for 79.1M Shs.***	***Intrinsic Value***
Base Case Option	$7.91	--	--	--
Weekly 5 Yr. Volatility/Yield	$10.44	+$2.53	+$200.1M	--
Monthly 3 Yr. Volatility/Yield	$6.99	-$.92	-$72.8M	--
Base Case @ $10 Discount	$13.00	+$5.09	+$402.6M	+$791.0M
Base Case @ $10 Premium	$4.75	-$3.16	-$250.0M	-$791.0M

Implications

SHARE USAGE

Annual "run rates" and dilution are coming down . . .

- **New plan adoptions and share replenishments threatened by shareholder rejection**
  - **-- NYSE/Nasdaq rule changes increase institutional investor power**
  - **-- cannot depend on others if negative ISS recommendation**
- **Plan language to obtain favorable voting outcome, e.g., as- issued share count, full-value share limits, etc.**

Implications

OPTION GRANT GUIDELINES

Accelerated movement toward dilution-based grant-size determination . . .

- **Shift from focus on granting competitive individual values to granting competitive total shares**
- **Pay surveys only useful for deciding competitive allocations**
  - **-- otherwise, values are distorted by stock prices and irrelevant to institutional investors**
- **Reduced share usage will force down executive grant amounts and lower-level participation**

OPTION PROVISIONS

Relatively <u>more</u> attractive under FAS 123 . . .

Provision	***Advantage to NQSOs***
Stock SARs	Fewer shares issued
Discount Price	Low cost to intrinsic value
Combined Dividend Rights	Low cost to intrinsic value
Performance Vesting	Pay-for-performance
Indexed Price	Pay-for-performance

Implications

OPTION PROVISIONS

Relatively less attractive under FAS 123 . . .

Provision	***Disadvantage to NQSOs***
ISOs	No tax benefit
Reloads	Additive cost
Cash SARs	Variable cost
Premium Price	High cost to intrinsic value

Implications

OPTION MIX

Converting high Black-Scholes values to cash, full-value shares, and SERPs is appealing but wrong . . .

	Recent Price	***Black-Scholes Multiple***	***Equivalent Cash/ Full-Value Shares***
AOL	$13.00	52.37%	$6.81
Citigroup	$30.00	22.15%	$6.65
Intel	$16.00	49.53%	$7.92
3M	$120.00	25.08%	$30.10
United Airlines	$2.50	34.49%	$.86

Implications

FULL-VALUE SHARES

Better than options for matching disclosed or real expense with delivered after-tax value . . .

Assume 40% Black-Scholes value, 35% company tax rate, and 45% individual rate

	Per $1 of Grant Value			
	NQSOs		*Full-Value Shares*	
Stock Price	*FAS 123 Expense*	*Pay Delivered*	*FAS 123 Expense*	*Pay Delivered*
Declines 50%	$.65	$.00	$.65	$.28
No Change	$.65	$.00	$.65	$.55
Increases 50%	$.65	$.69	$.65	$.83
Doubles	$.65	$1.38	$.65	$1.10

Implications

ANNUAL BONUS RESTRICTED STOCK

Ownership, retention, and pay-for-performance without difficult multi-year goal setting (caution: annual bonus restricted stock should not be benefit bearing) . . .

1. **Reduce Long-Term Grants**
2. **Correspondingly increase target annual bonus opportunities**
3. **Pay original annual bonus amount in cash**
4. **Distribute restricted stock for increased amount**

Implications

ESPPs

Plans terminated or provisions tightened to control disclosed or real FAS 123 expense . . .

- **No expense if discount is 5% or less at purchase**
- **Typical plans would have expense for 15% discount element and "look-back option"**
- **Assume 1 year purchase period and shares bought at lower of 85% of starting or ending price**
  - **-- expense 15% of starting price**
  - **-- plus Black-Scholes value of 1 year option at starting price**

Implications

OPTION REPRICING

Conditions will have to be met for shareholder approval . . .

- **At least 6 months and 1 day before new options are granted**
- **Proxy executives and outside directors excluded**
- **Value-for-value exchange**
  - **-- i.e., fewer new at-the-money options to replace canceled underwater options**
- **Recent Kodak action will be the model**

Implications

OWNERSHIP GUIDELINES

Retention-based guidelines beat traditional %-of-salary guidelines for long-term accumulation in a volatile market . . .

Pre-tax option profit @ exercise	$100,000
Tax @ 45% individual rate	- $45,000
After-tax value	$55,000
Assumed company share price	÷ $55
Net shares acquired	1,000

Must retain 750 shares (75%)

Free to sell 250 shares (25%)

Conclusion

PLANNING CONSIDERATIONS

If you want to be proactive now . . .

1. **Start voluntary quarterly pro forma option expense disclosure**
2. **Use lowest reasonable Black-Scholes value for expense**
3. **Re-examine option provisions and mix of options versus full-value shares**
4. **Only elect FAS 123 if it reduces otherwise disclosed expense**
5. **Adopt dilution-based grant guidelines**
6. **Run ISS methodology if you need more shares**

Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement*

Grant Type	Impact on Net Income: APB 25	Impact on Net Income: FAS 123	Effect of Adopting FAS 123 For Cost Recognition
Incentive Stock Options (ISOs):	▪ Compensation cost *not* recognized for options granted "at-the-money"	▪ Grant date fair value recognized as compensation cost over vesting period ▪ Compensation cost *not* tax effected	▪ Reported net income and EPS reduced for compensation cost
Nonqualified Stock Options (NQSOs):	▪ Compensation cost *not* recognized for options granted "at-the-money"	▪ Grant date fair value recognized as compensation cost over vesting period ▪ Compensation cost is tax effected	▪ Reported net income and EPS reduced for compensation cost (net of tax)
"Reload" Stock Options:	▪ Compensation cost *not* recognized for options with a reload feature, provided that (1) the reload feature is pursuant to the original terms of the award, (2) reload options are granted "at-the-money," and (3) shares tendered in stock-for-stock exercise are "mature," i.e., held for at least six months	▪ Grant date fair value recognized as compensation cost over vesting period *for each reload grant*	▪ Reported net income and EPS reduced for compensation cost (net of tax)

* Refer to last page of this document for a brief summary of the rules for calculating compensation cost under FAS 123; all technical views should be verified with the company's professional accountants

Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement* (cont'd)

Grant Type	Impact on Net Income: APB 25	Impact on Net Income: FAS 123	Effect of Adopting FAS 123 For Cost Recognition
Performance-Vesting Stock Options:	▪ Compensation cost *not* recognized if options ultimately vest regardless of performance contingencies, i.e., performance-accelerated vesting ▪ Otherwise, "variable-plan" mark-to-market compensation cost rec-ognized up to attainment of per-formance criteria	▪ Grant date fair value recognized as compensation cost over vesting period, with appropriate option pricing model adjustments for "path dependent" stock options if the performance criteria are based on stock price goals ▪ No reversal of compensation cost for unearned awards is permitted if performance criteria are based on "stock price" or "intrinsic value" goals	▪ Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
"Premium" Stock Options:	▪ Compensation cost *not* recognized for options granted "out-of-the-money"	▪ Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for premium exercise price	▪ Reported net income and EPS reduced for compensation cost (net of tax)
"Discount" Stock Options:	▪ "Fixed-plan" compensation cost recognized over vesting period, equal to discount at grant date	▪ Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for dis-count exercise price ▪ Fair value of discount stock option is *less* than the sum of (1) the discount, and (2) the fair value of an at-the-money stock option	▪ Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively

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Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement* (cont'd)

Grant Type	Impact on Net Income: APB 25	Impact on Net Income: FAS 123	Effect of Adopting FAS 123 For Cost Recognition
"Indexed" Stock Options:	▪ "Variable-plan" mark-to-market compensation cost recognized up to establishment of exercise price	▪ Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for stock-price volatility and risk-free interest rate ▪ Volatility input is based on "cross volatility" (the relation between the volatility of the company's stock and the volatility of the index stocks), and risk-free interest rate input is based on the dividend yield of the index stock	▪ Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
Stock Options With Dividends:	▪ Compensation cost *not* recognized for options, provided that the divi-dends are not deemed to change either the number of shares granted or the exercise price ▪ Amount of dividends credited recognized as compensation cost in period credited	▪ Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model input for dividends (generally a dividend input of zero)	▪ Reported net income and EPS reduced to extent compensation cost (net of tax) exceeds that of APB 25

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Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement* (cont'd)

Grant Type	*Impact on Net Income*		*Effect of Adopting FAS 123 For Cost Recognition*
	APB 25	*FAS 123*	
Stock Appreciation Rights (SARs) Paid in Stock:	▪ "Variable-plan" mark-to-market compensation cost recognized up to exercise of SAR	▪ Grant date fair value recognized as compensation cost over vesting period ▪ Same accounting treatment as NQSO, but no "investment" is required by employee	▪ Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
Stock Appreciation Rights (SARs) Paid in Cash:	▪ "Variable-plan" mark-to-market compensation cost recognized up to exercise of SAR	▪ Variable mark-to-market compensa-tion cost recognized up to exercise of SAR	▪ Reported net income and EPS should *not* change, because com-pensation cost is calculated the same under APB 25
Performance Shares Paid in Stock:	▪ "Variable-plan" mark-to-market compensation cost recognized over earnout/vesting period ▪ No reduction in compensation cost if dividends not paid during earnout/vesting period ▪ Additional compensation cost is recognized for dividends paid on share "units"	▪ Grant date fair value recognized as compensation cost over earnout/vest-ing period ▪ Fair value reduced to extent divi-dends not credited over earn-out/vesting period	▪ Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively

* Refer to last page of this document for a brief summary of the rules for calculating compensation cost under FAS 123; all technical views should be verified with the company's professional accountants

Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement* (cont'd)

Grant Type	Impact on Net Income: APB 25	Impact on Net Income: FAS 123	Effect of Adopting FAS 123 For Cost Recognition
Performance Shares Paid in Cash:	▪ "Variable-plan" mark-to-market compensation cost recognized over earnout/vesting period	▪ Variable mark-to-market compensa-tion cost recognized over earn-out/vesting period	▪ Reported net income and EPS should *not* change, because compensation cost is calculated the same under APB 25
Restricted Stock, Performance Accelerated Restricted Stock (PARs), and Restricted Stock Units Paid in Stock:	▪ "Fixed-plan" compensation cost recognized over vesting period, equal to fair market value of stock at grant date ▪ No reduction in compensation cost if dividends not paid during earnout/vesting period ▪ Additional compensation cost is recognized for dividends paid on share "units"	▪ Grant date fair value recognized as compensation cost over vesting period ▪ Fair value reduced to extent divi-dends not credited over earn-out/vesting period	▪ Reported net income and EPS should *not* change (unless divi-dends not credited), because com-pensation cost is calculated the same under APB 25

* Refer to last page of this document for a brief summary of the rules for calculating compensation cost under FAS 123; all technical views should be verified with the company's professional accountants

Grant Type Comparison of APB 25 vs. FASB 123 Impact on Income Statement* (cont'd)

Grant Type	*Impact on Net Income*		*Effect of Adopting FAS 123 For Cost Recognition*
	APB 25	*FAS 123*	
Restricted Stock Units Paid in Cash:	▪ "Variable-plan" mark-to-market compensation cost recognized over vesting period	▪ Variable mark-to-market compensa-tion cost recognized over vesting period	▪ Reported net income and EPS should *not* change, because com-pensation cost is calculated the same under APB 25
Employee Stock Purchase Plans:	▪ Compensation cost *not* recognized for stock purchase plans, provided that the "noncompensatory plan" requirements are satisfied	▪ Grant date fair value recognized as compensation cost over vesting period, unless the plan (1) has minimal "option" features (2) has a relatively small purchase discount, e.g., 5 percent or less, and (3) is generally available to all employees on an equitable basis ▪ Special adjustments to fair value for purchase plans with "look-back" features ▪ Compensation cost *not* tax affected for tax-qualified plans, but is tax affected for nonqualified plans	▪ Reported net income and EPS reduced for compensation cost (net of tax for nonqualified plans)

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Calculation of Compensation Cost Under FASB 123

In general, compensation cost under FAS 123 is equal to a stock-based award's "fair value" at grant, less the amount (if any) paid by the award recipient. Compensation cost is generally recognized ratably over the award's vesting period, except for certain stock options with pro rata vesting schedules (as opposed to "cliff" vesting schedules) that may be subject to an accelerated accrual methodology. Compensation cost is generally *not* recognized for stock-based awards that do not vest, unless the forfeiture is due to the expiration of unexercised vested stock options or the failure to satisfy certain "stock price" or "intrinsic value" performance conditions. Compensation cost is generally recognized "net-of-tax" for stock-based awards which normally give rise to tax deductions (such as nonqualified stock options), but is not tax effected for awards which normally are not tax deductible (such as incentive stock options or tax-qualified employee stock purchase plans). Lastly, no "discounts" or "haircuts" from fair value are permitted for the nontransferability and forfeiture restrictions typically imposed on employee stock options.

Compensation cost for stock options and stock appreciation rights (SARs) payable in stock is calculated using a Black-Scholes or binomial pricing model that takes into account at grant the following six variables:

1. Fair market value of stock
2. Exercise price of option
3. Risk-free interest rate
4. Expected life of option
5. Expected stock price volatility
6. Expected dividends on stock

Calculation of Compensation Cost Under FASB 123 (cont'd)

The calculation of compensation cost for other stock-based awards such as performance shares or restricted stock depends on whether the awards are to be settled in stock or cash. For awards that are to be paid in stock, compensation cost is generally equal to the fair market value of the underlying stock on the date of grant. Unlike Opinion 25, the treatment applies equally to awards with service- or performance-based vesting requirements. Dividends (if any) paid during the vesting period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited. Compensation cost for non-dividend-paying awards is reduced by the present value of estimated forgone dividends over the vesting period.

For stock-based awards that call for cash settlement, compensation cost is calculated in the same variable "mark-to-market" fashion as currently exists under Opinion 25. Special rules apply for stock-based awards with unique or complex features (such as "indexed" or "dividend-paying" stock options), and for awards which are subsequently modified or settled in cash.

The guidance above for stock options also generally applies to broad-based employees stock purchase plans that incorporate "option" features or purchase discounts in excess of 5 percent. For stock purchase plans with a purchase price equal to the "lesser of" stock price at the beginning or end of the purchase period, compensation cost is calculated under a complex methodology that assumes the award is composed of (1) a non-dividend-paying share of stock equal in value to the purchase discount, and (2) an at-the-money stock option equal in value to the discounted purchase price.

Company Profile

Frederic W. Cook & Co., Inc. provides management compensation consulting services to business clients. Formed in 1973, our firm has served over 1,300 corporations in a wide variety of industries from our offices in New York, Chicago, and Los Angeles. Our primary focus is on performance-based compensation programs which help companies attract and retain key employees, motivate and reward them for improved performance, and align their interests with shareholders. Our range of consulting services encompasses the following areas:

- Total Compensation Review
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- Specific Plan Reviews
- Restructuring Services
- Competitive Comparisons
- Incentive Grant Guidelines
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- All-Employee Plans
- Directors' Compensation
- Equity Instruments
- Performance Measurement
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- Privatization
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- Stock Option Enhancements

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