

AYCO
INNER CIRCLE

SUMMER PROGRAMS

2003



Executive and Board Compensation
What Now?

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New Jargon



EBIT: Earnings Before Irregularities and Tampering

ROIC: Restated on Instructions of Counsel

CFO: Chief Fraud Officers

State of the World

- 89% think company executives lie
- 80% think they are paid too much
- 75% think pension commitments will not be honored
- A good number of CEOs are sociopaths
 - “a person with a personality disorder manifesting itself in extreme antisocial attitude and behavior”

Two Topics

- Executive Compensation Update (Post-MSFT)
 - Accounting
 - US
 - MSFT
- Paying the Board

Obligatory Accounting Update

Best Guess:

WHAT

- “Principles-based” valuation model
 - Contingent Claims-based models (i.e., binomial, Monk Carlo simulation, etc.) to calculate the “fair value” of an option consistent with “what market participants would utilize”
- FASB advised to refrain from specific guidance, “safe harbors” of any “haircuts” in order to signal valuation precision based
- Specific company experiences and circumstances
- No decision yet on tax deduction
 - Compensation expense or equity transaction
 - Leaning towards equity, i.e., no P/L effect

Obligatory Accounting Update (cont'd)

WHEN

- Follow IASB?
 - Effective for periods beginning on or after 1/1/04
 - Covers grants made after 11/7/02 (Exposure Draft)
- FASB
 - Exposure draft by end of 2003
 - Effective 1/1/04 or 3/04?

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

	<i>Option Value per Share</i>	<i>+/- Base Case</i>		
		<i>per Share</i>	<i>Total for 79.1M Shs.</i>	<i>Intrinsic Value</i>
Base Case Option	\$7.91	--	--	--
Weekly 5 Yr. Volatility/Yield	\$10.44	+\$2.53	+\$200.1M	--
Monthly 3 Yr. Volatility/Yield	\$6.99	-\$0.92	-\$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

Early Indications from Top 250 Survey

- Stock option prevalence almost identical and universal (98%)
- Restricted stock usage has increased (43% to 49%)
- Companies that have adopted FAS 123, restricted stock usage at 70%
- Performance share and unit plans same as last year (26% and 17%, respectively)

Top 250 Interim Summary

Company	Total Cos.	Adopted FAS 123	Executive Grant Types									
			Stock Options	Restricted Stock	PARSAP	Perf. Shares	Perf. Units	Tandem Grants	Freestanding SARs	Tandem SARs	Additive SARs	Formula Value
Historical			97%	42%	2%	24%	14%	0%	0%	1%	0%	0%
New			2%	4%	2%	1%	2%	0%	0%	0%	0%	0%
Prospective			0%	3%	0%	2%	0%	0%	0%	0%	0%	0%
TOTAL	250	65	98%	48%	4%	26%	17%	0%	0%	1%	0%	0%

↑
Out of full 268

	Executive Stock Option Features						Executive Annual Incentives Paid in Stock					
	Reloads	Perf. Accelerated	Perf. Based	Premium-Priced	Discount	Indexed	Gain Deferral	Mandatory SO or Shrs	Elective SO or Shrs	% Premium (if any)	% Discount (if any)	
TOTAL	14%	8%	2%	2%	0%	0%	2%	14%	9%	9%	5%	

Company	FAS 123 Cos.	Adopted FAS 123	Executive Grant Types									
			Stock Options	Restricted Stock	PARSAP	Perf. Shares	Perf. Units	Tandem Grants	Freestanding SARs	Tandem SARs	Additive SARs	Formula Value
Historical			92%	58%	2%	34%	17%	2%	0%	3%	0%	0%
New			5%	5%	5%	0%	2%	0%	0%	0%	0%	0%
Prospective			0%	5%	0%	3%	0%	0%	2%	0%	0%	0%
TOTAL		65	97%	68%	6%	37%	18%	2%	2%	3%	0%	0%

	Executive Stock Option Features						Executive Annual Incentives Paid in Stock					
	Reloads	Perf. Accelerated	Perf. Based	Premium-Priced	Discount	Indexed	Gain Deferral	Mandatory SO or Shrs	Elective SO or Shrs	% Premium (if any)	% Discount (if any)	
TOTAL	23%	5%	3%	2%	0%	0%	3%	28%	8%	14%	11%	

Historical: Grant type used in the past and continues to be used
 New: Grant type first used on a "regular" basis starting in 2002
 Prospective: Grant type not yet in use, but company indicated use beginning in 2003

Microsoft Program

- All employees eligible to receive restricted stock units
- No dividend equivalents
- No 83(b) election; no 15% tax
- Top 1% also receive performance shares
 - 3-year end to end performance

Microsoft Program (cont'd)

- Pending SEC approval
- Optionees can sell vested and unvested options
JPMorganChase
- Estimate provided by JPM:
 - Exercise price \$33
 - Current price \$25
 - Value \$2
 - Black-Scholes \$2.89 (3 yrs.) - \$9.97 (7 yrs.)
- Payable over three years

MSFT Crossover Analysis

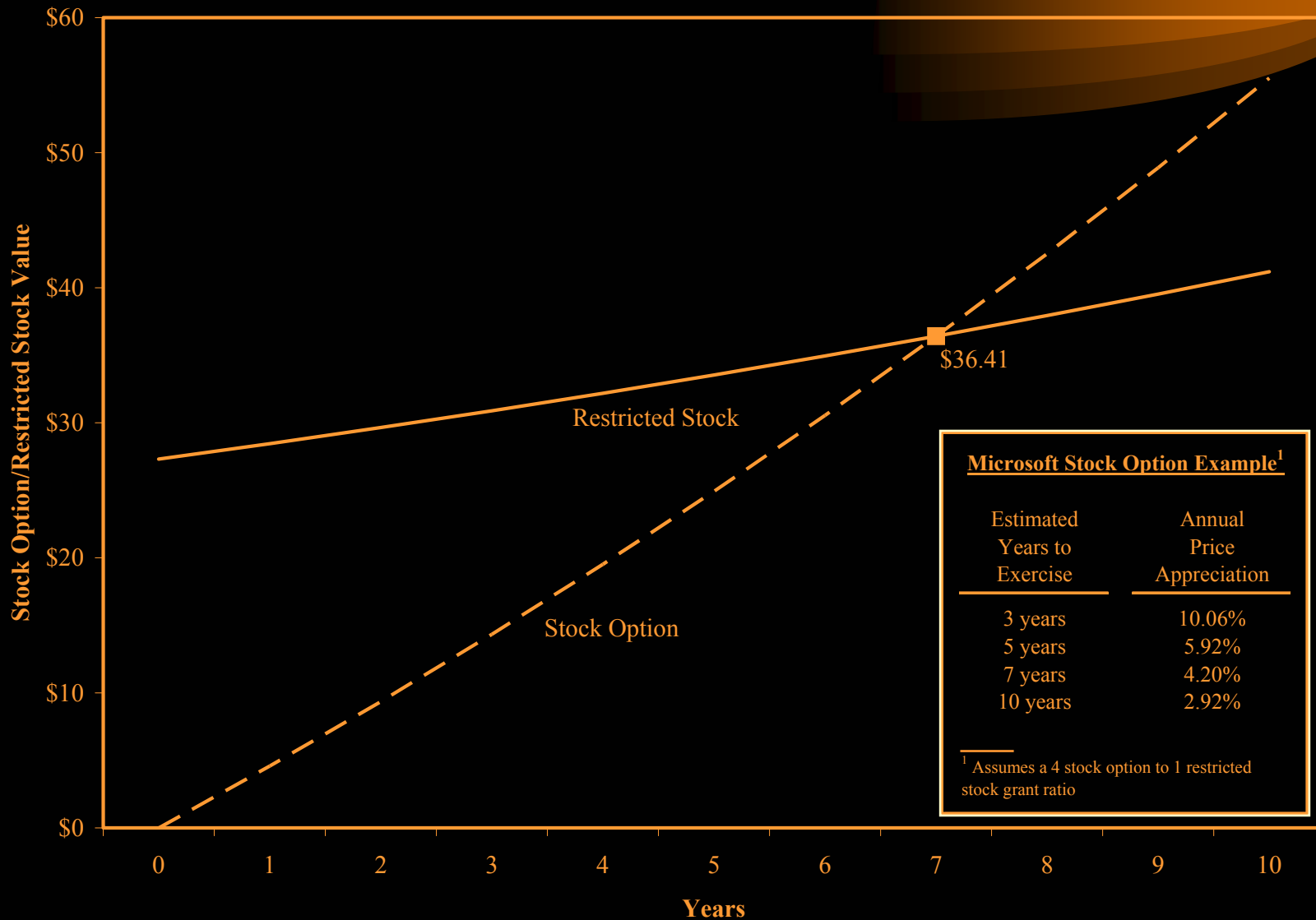


Chart assumes Microsoft's FAS 123 expected term of 7 years, annual price appreciation of 4.20%, an initial price of \$27.31 (the closing price of Microsoft on 7/11/03), and a grant ratio of 4 options to 1 restricted stock

Many Different Forms

Equity compensation is not just stock options...

Long-Term Incentives

Options

SARs

Restricted Stock

Performance Stock

Savings/Investment and Deferrals

ESPPs

401(k) Matching

Voluntary Deferrals

Mandatory Deferrals

ERISA Excess, SERPs

Stock in Lieu of Cash

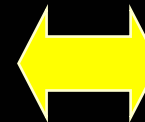
Outright Shares

Options

Restricted Stock

Winners/Losers

- Options
- SARs (Stock)
- SARs (Cash)
- Reloads
- Discount Options
- Premium Options



Winners/Losers (cont'd)

- Indexed/Performance Options 
- ISOs 
- Dividend Rights 
- Restricted Stock 
- Performance Shares 

One Possible Program



	<u>Current</u>	<u>Future</u>
Stock Options	100%	33%
Restricted Stock	Selective	33% (with haircut)
Performance Shares	Some	33%

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

<i>Stock Price</i>	<i>Per \$1 of Grant Value</i>			
	<i>NQSOs</i>		<i>Full-Value Shares</i>	
	<i>FAS 123</i>	<i>Pay</i>	<i>FAS 123</i>	<i>Pay</i>
	<i>Expense</i>	<i>Delivered</i>	<i>Expense</i>	<i>Delivered</i>
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

Option Mix

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

	<i>Recent Price</i>	<i>Black- Scholes Multiple</i>	<i>Equivalent Cash/ Full-Value Shares</i>
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

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) . . .



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	<hr/> \$55,000
Assumed company share price	÷ \$55
Net shares acquired	<hr/> 1,000

Must retain 750
shares (75%)







Free to sell 250
shares (25%)

Trends in Paying the Board

- Compensation
- Simplification
- Benefits and Long-Vesting
- Perquisites
- Lead Director Retainers
- Committee Chair Retainers



Trends in Paying the Board (cont'd)

- Committee Member Retainers 
- Stock Options 
- Restricted/Deferred Stock 
- Limitations on Stock Sales 
- Use of Ownership Guides/
Retention Ratios 
- Charitable Bequest Programs 

Illustrative Committee Chair Fees

	<u>Audit</u>	<u>Compensation</u>	<u>Other</u>
AFLAC	\$19,200	\$17,200	--
Chubb	15,000	15,000	--
Honeywell	12,000	12,000	10,000
i2 Technologies	50,000	10,000	--
Sara Lee	10,000	5,000	5,000
TRW	7,000	7,000	5,000

Illustrative Lead Director Retainers

	<u>Additional Pay</u>
Catellus Development	\$100,000
Household International	42,000
Lucent	100,000 + 5,000 options
TJX	70,000
Median	18,000
Average	28,000

GE Example

	Old	New
<i>Retainer</i>	\$37,500 cash \$37,500 stock	\$100,000 cash \$150,000 DSUs
<i>Meeting Fees</i>	\$2,000	0
<i>Audit/Comp. Members</i>	0	\$25,000 extra for each (40%/60%)
<i>Stock Options/Grants</i>	18,000 options (\$168,000) 5,000 one-time grant	0
<i>Stock Ownership</i>	None	DSUs paid 1 year after retirement
<i>Charitable Bequest</i>	\$1 million at retirement	\$1 million at termination of service

Grant Type Comparison of APB 25 vs. FASB 123

Impact on Income Statement*

<i>Grant Type</i>	<i>Impact on Net Income</i>		<i>Effect of Adopting FAS 123 For Cost Recognition</i>
	<i>APB 25</i>	<i>FAS 123</i>	
<i>Incentive Stock Options (ISOs):</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> recognized for options granted “at-the-money” 	<ul style="list-style-type: none"> • Grant date fair value recognized as compensation cost over vesting period • Compensation cost <i>not</i> tax effected 	<ul style="list-style-type: none"> • Reported net income and EPS reduced for compensation cost
<i>Nonqualified Stock Options (NQSOs):</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> recognized for options granted “at-the-money” 	<ul style="list-style-type: none"> • Grant date fair value recognized as compensation cost over vesting period • Compensation cost is tax effected 	<ul style="list-style-type: none"> • Reported net income and EPS reduced for compensation cost (net of tax)
<i>“Reload” Stock Options:</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> 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 	<ul style="list-style-type: none"> • Grant date fair value recognized as compensation cost over vesting period <i>for each reload grant</i> 	<ul style="list-style-type: none"> • 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)*

<i>Grant Type</i>	<i>Impact on Net Income</i>		<i>Effect of Adopting FAS 123 For Cost Recognition</i>
	<i>APB 25</i>	<i>FAS 123</i>	
<i>Performance-Vesting Stock Options:</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> recognized if options ultimately vest regardless of performance contingencies, i.e., performance-accelerated vesting • Otherwise, “variable-plan” mark-to-market compensation cost recognized up to attainment of performance criteria 	<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • 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
<i>“Premium” Stock Options:</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> recognized for options granted “out-of-the-money” 	<ul style="list-style-type: none"> • Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for premium exercise price 	<ul style="list-style-type: none"> • Reported net income and EPS reduced for compensation cost (net of tax)
<i>“Discount” Stock Options:</i>	<ul style="list-style-type: none"> • “Fixed-plan” compensation cost recognized over vesting period, equal to discount at grant date 	<ul style="list-style-type: none"> • Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for discount exercise price • Fair value of discount stock option is <i>less</i> than the sum of (1) the discount, and (2) the fair value of an at-the-money stock option 	<ul style="list-style-type: none"> • 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)*

<i>Grant Type</i>	<i>Impact on Net Income</i>		<i>Effect of Adopting FAS 123 For Cost Recognition</i>
	<i>APB 25</i>	<i>FAS 123</i>	
<i>“Indexed” Stock Options:</i>	<ul style="list-style-type: none"> • “Variable-plan” mark-to-market compensation cost recognized up to establishment of exercise price 	<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • 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
<i>Stock Options With Dividends:</i>	<ul style="list-style-type: none"> • Compensation cost <i>not</i> recognized for options, provided that the dividends 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 	<ul style="list-style-type: none"> • 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) 	<ul style="list-style-type: none"> • Reported net income and EPS reduced to extent compensation cost (net of tax) exceeds that of APB 25

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- Total Compensation Reviews
- Strategic Incentives
- Specific Plan Reviews
- Restructuring Services
- Competitive Comparisons
- Incentive Grant Guidelines
- Executive Ownership Programs
- All-Employee Plans
- Directors' Compensation
- Equity Instruments
- Performance Measurement
- Globalization
- Privatization
- Compensation Committee Advisor
- Stock Option Enhancements

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