

FREDERIC W. COOK & CO., INC.

FVT

FAIR VALUE TRANSFER

*Alternative Approach to
Determining Aggregate Long-Term
Incentive Grant Sizes*

JANUARY 2006

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In connection with the administration of a company's long-term incentive program, Compensation Committees and Boards of Directors annually ask themselves:

What should we be spending, in the aggregate, on long-term incentive grants?

What total share usage is competitive for a company of our size and in our industry?

Companies traditionally answered these important questions in two different ways. The first was to compare its own annual share usage rate measured as a percentage of average outstanding company shares, i.e., the "run rate," or "burn rate," against those of its peers or general industry practices. The second was to look at its "overhang," i.e., the number of shares represented by outstanding grants and available shares remaining for future grants as a percentage of total fully diluted company shares at year end, also versus its peers or general industry practices.

Over the past several years, however, companies have started rethinking their long-term incentive (LTI) compensation strategies in response to regulatory changes, shareholder pressures to constrain dilution, a movement away from options and toward full-value share grants, and market volatility. In 2004, the Financial Accounting Standards Board finalized the accounting mandate for stock option expensing, known as "Statement 123(R), Share-Based Payment." This mandate, which is probably the largest single influencing factor in recent history on long-term incentive design, went into effect for public companies whose fiscal years began after June 15, 2005, and requires that a compensation expense for all equity awards, including stock options, be recorded on a company's income statement at their grant date "fair value."

As a result, the two approaches generally used to answer the above questions have become less useful in that they count all shares equally, regardless of award type. While these approaches made sense when stock options made up the vast majority of LTI awards, with options no longer "free," companies have been re-evaluating their LTI programs and have started to shift to full-value grants, e.g., restricted stock and performance shares. Traditional share usage and dilution considerations have taken a back seat to the perspective of overall affordability as reflected on the company's income statement and the *value* of the awards being provided to employees.

OUR SUGGESTION: FAIR VALUE TRANSFER “FVT”

In order to more accurately evaluate the aggregate cost of equity incentive programs, we suggest that companies consider looking at the company’s fair value transfer (FVT), which measures the aggregate grant value and potential cost of LTI compensation awards.

The FVT method:

- Provides a measure of aggregate pre-tax compensation cost of grants made in a given year even though cost will likely be spread over multiple future years for profit and loss purposes
- Facilitates trade-offs between various LTI vehicles since all forms of awards are expressed on an economically equivalent basis
- Provides a better way of comparing proportionate costs of various grant types in an option expensing environment
- Differentiates the dilutive impact of various grant types; i.e., recognizes that an option has less immediate dilution than a full-value share
- For comparison purposes, annual FVT can be measured against either:
 - A company’s total equity market capitalization, or
 - An internal financial measure, such as revenue or net income

THE BENEFITS OF MEASURING FVT AS A PERCENTAGE OF MARKET CAPITALIZATION/REVENUE/NET INCOME

- Allows comparisons to be made across companies to assess the competitiveness and reasonableness of a given company’s aggregate LTI budget
- Eliminates distortion from stock price fluctuation, especially for those companies establishing grant guidelines based on competitive LTI values
- Is generally consistent with the way investor advisory groups, such as Institutional Shareholder Services (ISS), assess the reasonableness of company aggregate grant practices and new share requests
 - ISS recognized the issues associated with traditional measures of potential dilution and switched its primary methodology for evaluating the reasonableness of share authorization requests from traditional potential dilution to Shareholder Value Transfer (SVT). SVT measures outstanding and potential grant value as a percentage of market capitalization
 - In theory, ISS measures the portion of the company’s market value that can potentially be transferred to executives and employees through LTI grants. The ISS methodology infers that investors regard company market-cap value as a relevant reference point for comparing grant values (and costs) across companies
 - Although similar in concept to ISS’ SVT calculation, our FVT analysis focuses on annual usage (as opposed to total potential dilution), and uses a different methodology

METHODOLOGY

CALCULATION OF FAIR VALUE TRANSFER

- FVT measures the pre-tax “fair value” of equity awards granted during the year. For the purposes of this report, pre-tax fair value of equity awards was calculated for the most recent three years available using each company’s form 10-K disclosure, supplemented with information from the proxy statement as necessary
- Fair value is calculated as follows:
 - Options are valued using the weighted-average fair value of options granted during the year. If fair value is not disclosed in public filings, it was calculated using the binomial option pricing model and the FAS 123 input assumptions reported by that company
 - Restricted shares are valued at fair market value on grant date
 - Performance shares are valued at fair market value on grant date using target number of shares; cash-based LTI awards are valued at grant-date target value

Note: if aggregate grant data for restricted shares, performance shares and cash-based (performance unit) programs were not provided, aggregate grants made to the named executive officers disclosed in proxy statements were used, under the assumption that these executives receive the majority of the awards

- FVT as a percentage of market capitalization is calculated using an approximation of the weighted-average market capitalization at the time the grants were made

$$\text{FVT \%} = \frac{\text{Pre-Tax Fair Value of Equity Awards Granted During the Year}}{\text{Weighted-Average Market Capitalization}}$$

EXAMPLE:

Options Granted	1,000,000
Weighted-Average Exercise Price	\$50.00
Weighted-Average Fair Value of Options	\$15.00
<i>Aggregate Pre-Tax Option Fair Value</i>	<i>\$15,000,000</i>
Restricted/Performance Shares Granted	100,000
Weighted-Average Grant Price	\$50.00
<i>Aggregate Pre-Tax R.S. Fair Value</i>	<i>\$5,000,000</i>
FVT	\$20,000,000
Weighted-Average Basic Shares O/S	50,000,000
Weighted-Average Market Capitalization	\$2,500,000,000
<i>FVT % of Market Cap</i>	<i>0.80%</i>

A simple example illustrates the need to focus on value, highlighting the fact that while one stock option and one share of restricted stock are comparable on a share basis, they are clearly different in terms of value. In the example below, we grant half the number of shares as restricted stock, but double the value:

ASSUMPTIONS:

Shares Outstanding 100,000
 Stock Price \$10.00
 Binomial % of Stock Price 25%

	Stock Options	Restricted Shares	Change
# of	1,000	500	
Run Rate	1.00%	0.50%	-50%
Pre-Tax Value	2,500	5,000	
Fair Value Transfer	0.25%	0.50%	+100%

METHODOLOGY

RESEARCH SAMPLE

- To identify patterns in FVT usage among companies of different sizes and industry sectors, we selected 180 publicly traded companies based on market capitalization as of May 31, 2005 and industry categorization according to Standard & Poor's Global Industry Classification Standard Industry Group codes:

	Small Cap (Mkt. Cap. < \$1B)	Mid Cap (Mkt. Cap. \$1B-\$5B)	Large Cap (Mkt. Cap. > \$5B)	Total
Industrials	20	20	20	60
Retail	20	20	20	60
Hi-Tech	20	20	20	60
Total	60	60	60	180

— The selected companies are identified in the Appendix. 92% of the companies are the same as those evaluated in our February 2005 report; the remaining 8% were eliminated due to acquisitions and replaced with similar companies in terms of size and industry.

- Market capitalizations as of December 31, 2005 and trailing four quarters' revenues break down as follows:

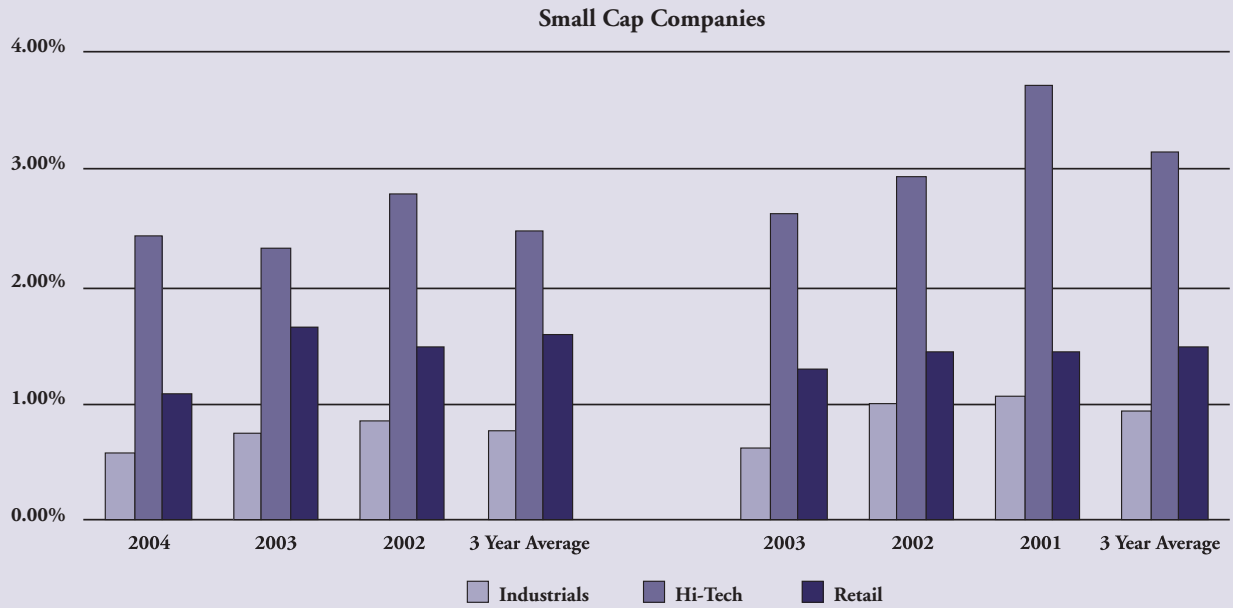
	Market Capitalization as of 12/31/05			Trailing 4 Qtrs. Revenue (\$mil.)			Market Cap. As Multiple of Revenue		
	25P	Median	75P	25P	Median	75P	25P	Median	75P
<i>Size Categories</i>									
Small	\$336	\$623	\$872	\$255	\$710	\$1,255	1.3	0.9	0.7
Mid	\$1,512	\$2,301	\$3,305	\$824	\$1,688	\$3,585	1.8	1.4	0.9
Large	\$9,924	\$17,406	\$47,919	\$5,653	\$12,547	\$27,609	1.8	1.4	1.7
<i>Industry Sectors</i>									
Industrial	\$881	\$1,972	\$8,938	\$1,165	\$3,011	\$10,801	0.8	0.7	0.8
Retail	\$742	\$2,527	\$8,690	\$1,330	\$3,563	\$8,649	0.6	0.7	1.0
Hi-Tech	\$682	\$1,862	\$10,761	\$243	\$647	\$1,894	2.8	2.9	5.7
Total Sample	\$822	\$2,205	\$9,751	\$726	\$1,976	\$6,990	1.1	1.1	1.4

- The charts on the following pages summarize median historical FVT results from this year's study vs. last year's in the aggregate and by various categories:
 - By Size
 - Small, Mid, and Large Cap companies
 - By Industry
 - Industrial, Retail, and Hi-Tech companies
 - By accounting treatment of stock options, i.e., FAS 123 vs. Non-FAS 123 companies
- For additional comparisons we have also shown FVT as a percentage of revenue and net income
- As expected, the data illustrate the following:
 - Aggregate results are generally showing a decline in FVT run rates as a percent of market capitalization in this year's study vs. last year's, indicating the continuous limitations being placed on LTI compensation
 - Traditional share run rates are also exhibiting a pattern of decline; aggregate median run rate among the sample companies has fallen from 2.54% in 2002 to 2.02% in 2004
 - These numbers are high due to the high annual usage among the technology companies
- The negative correlation between company size and aggregate FVT granted as a percentage of market capitalization supports the logic that smaller companies need to deliver greater LTI opportunity as a percentage of market capitalization than larger companies do in order to maintain competitive compensation programs
 - Hi-Tech companies have significantly higher FVT than other industries, with retail companies having the next highest and industrials having the lowest
 - Human capital-intensive companies such as those in the Hi-Tech industry are expected to need larger aggregate LTI budgets
 - Companies that have adopted FAS 123 are granting fewer (or less dilutive) long-term incentives than those who have not

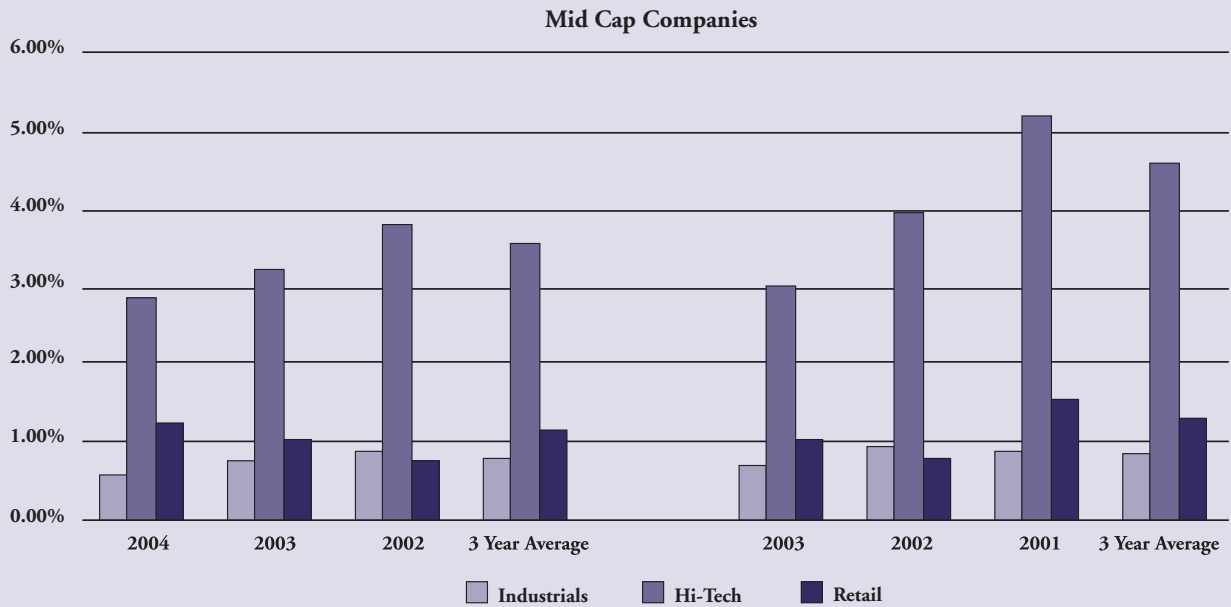
IMPLICATIONS

With the implementation of Statement 123(R) and the continued uncertainty as to how the financial markets will react to lower EPS levels, it was correctly anticipated that companies would begin to moderate the aggregate amount “spent” on long-term equity incentive programs. As illustrated by the summary findings that follow, aggregate FVT is generally dropping among all companies, with the drop more pronounced in those companies that have voluntarily adopted FAS 123. We believe that this shift is a harbinger of more reductions in the future.

MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY SIZE – SMALL CAP

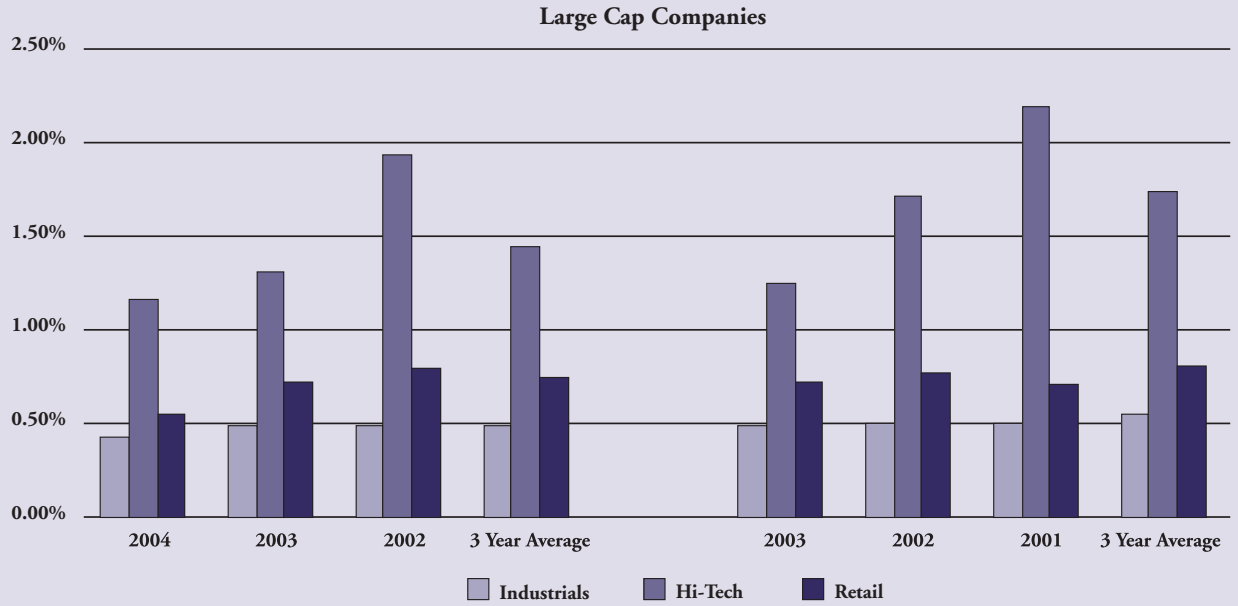


MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY SIZE – MID CAP

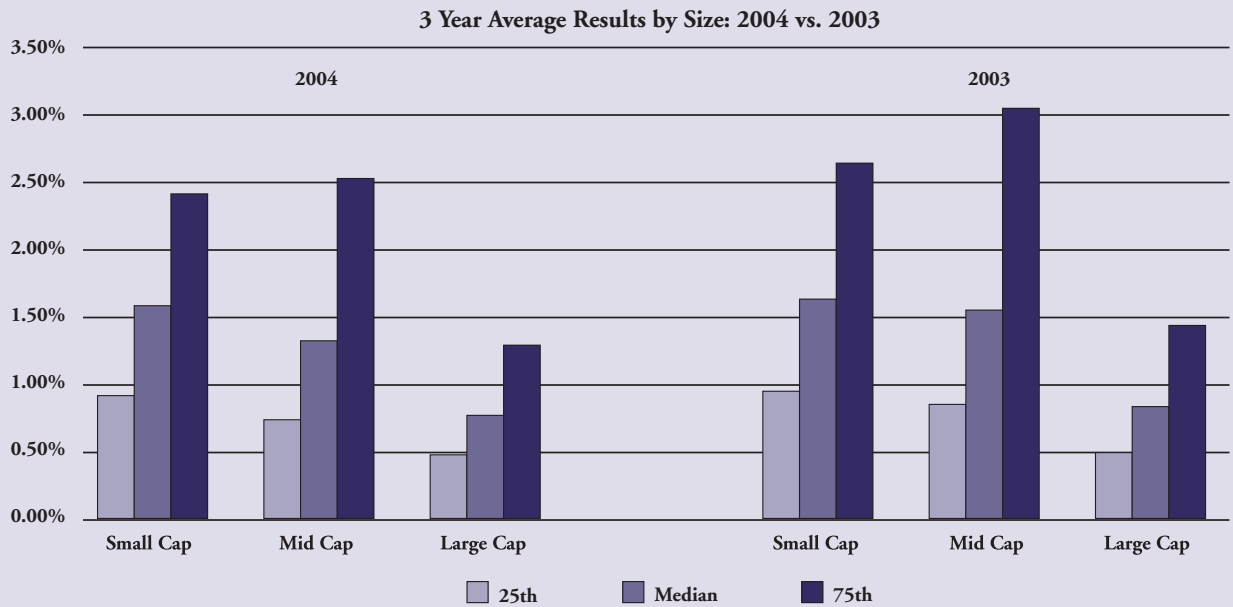


SUMMARY FINDINGS

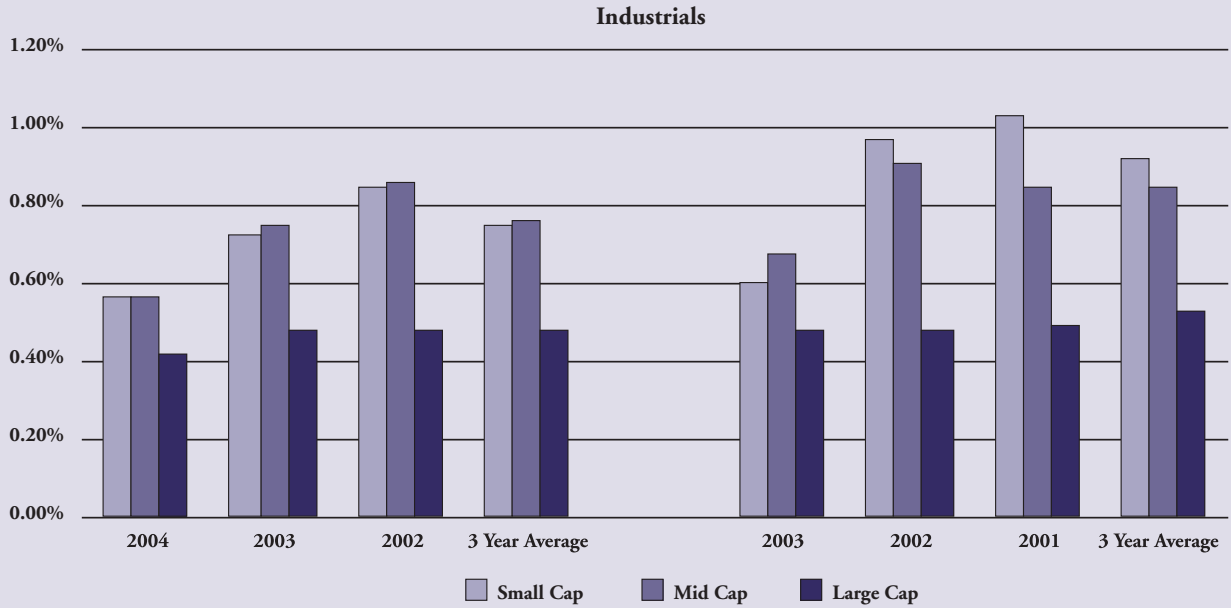
MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY SIZE – LARGE CAP



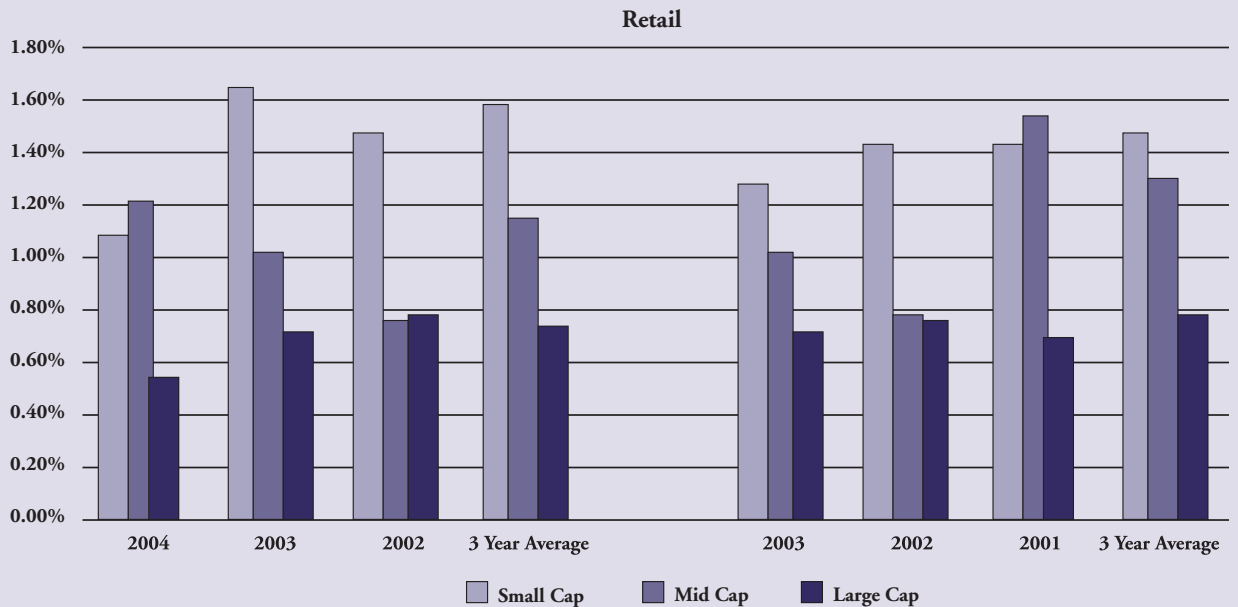
FVT % OF MARKET CAPITALIZATION: DETAIL BY SIZE – AGGREGATE



MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY INDUSTRY – INDUSTRIALS

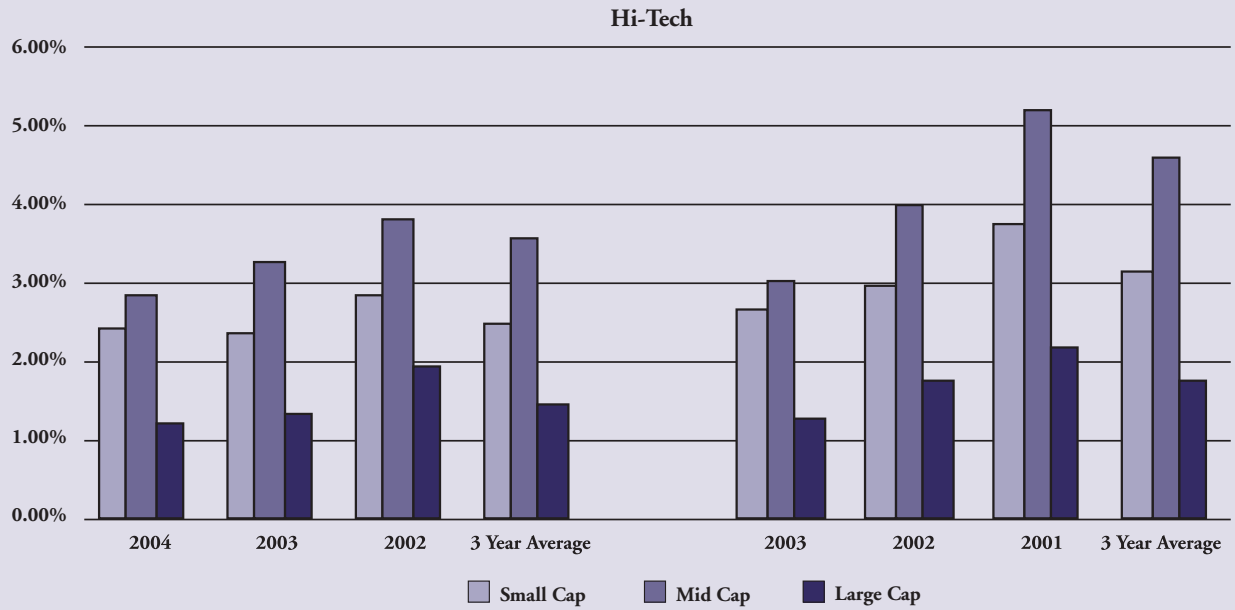


MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY INDUSTRY – RETAIL

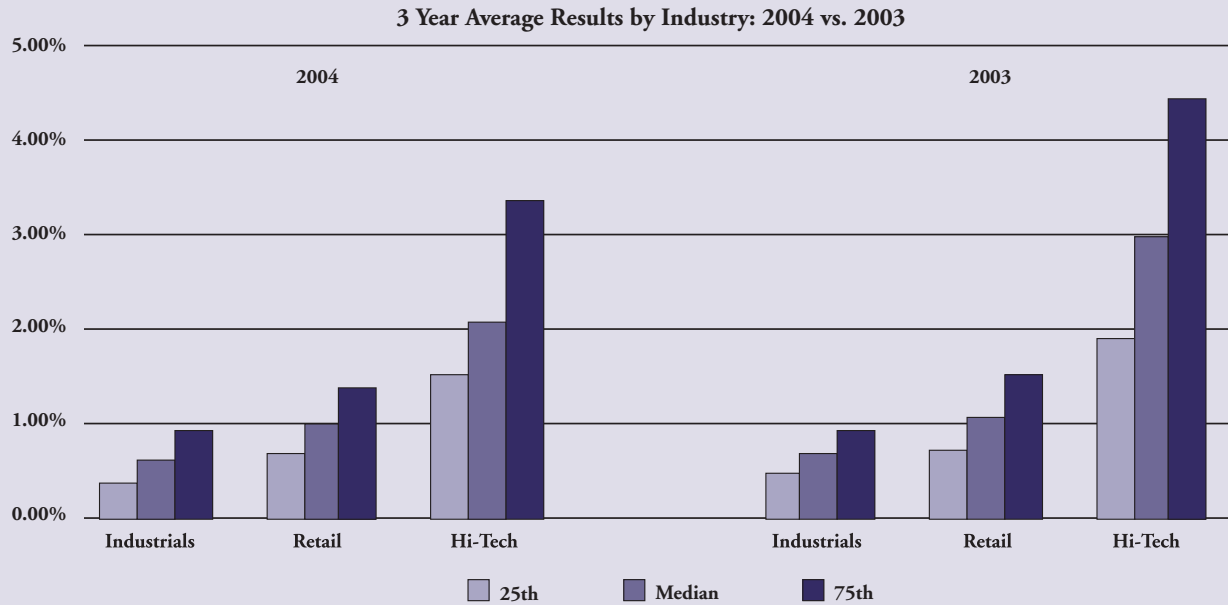


SUMMARY FINDINGS

MEDIAN FVT % OF MARKET CAPITALIZATION: DETAIL BY INDUSTRY – HI-TECH

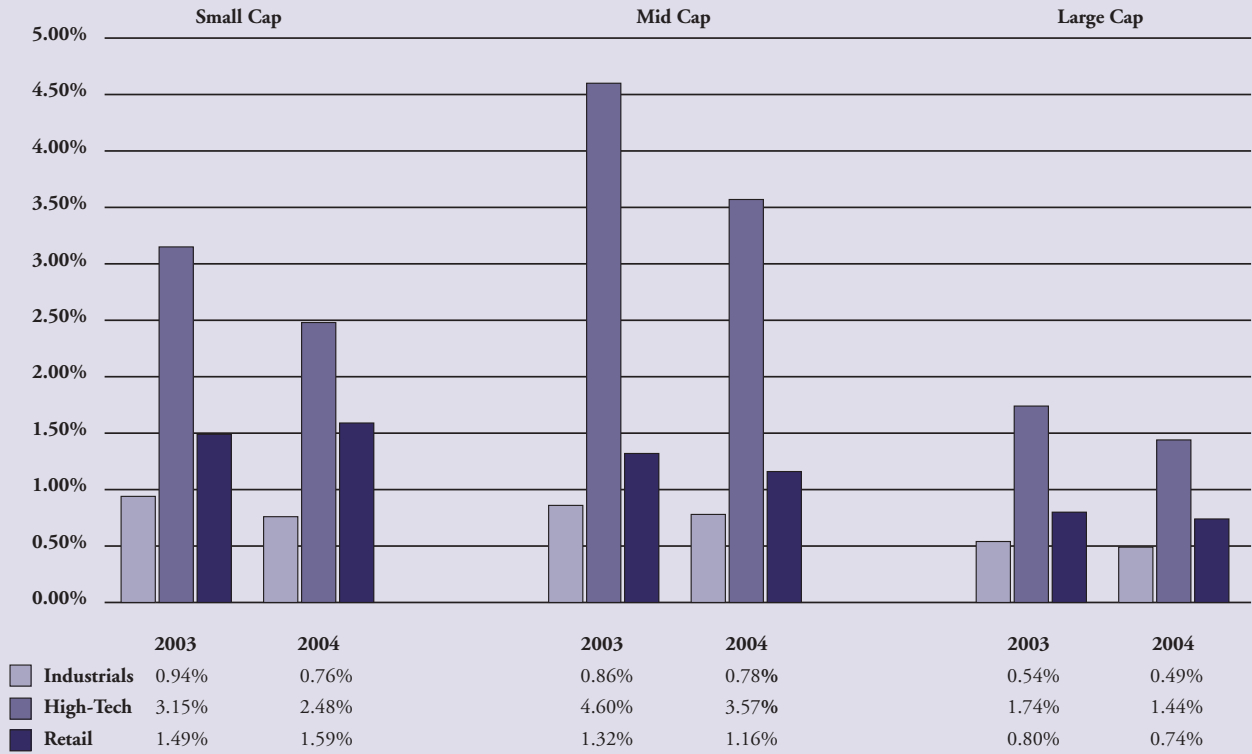


FVT % OF MARKET CAPITALIZATION: DETAIL BY INDUSTRY – AGGREGATE



FVT % OF MARKET CAPITALIZATION – AGGREGATE REPORT RESULTS

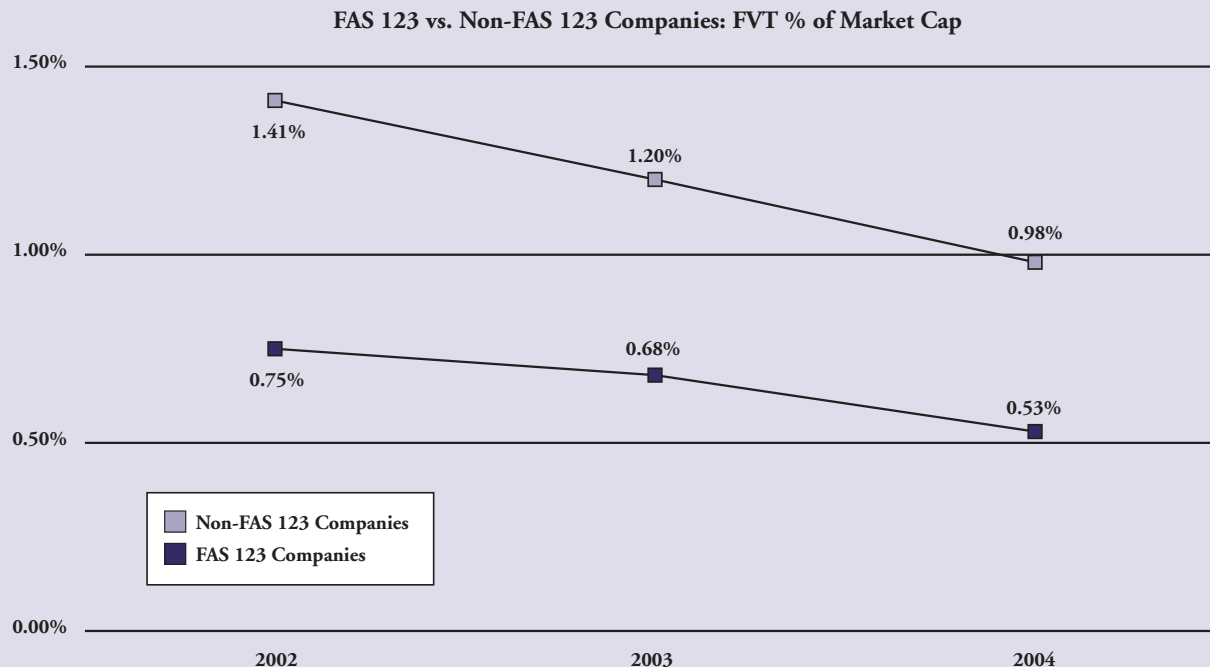
3-Year Average Median FVT as % of Market Cap



SUMMARY FINDINGS

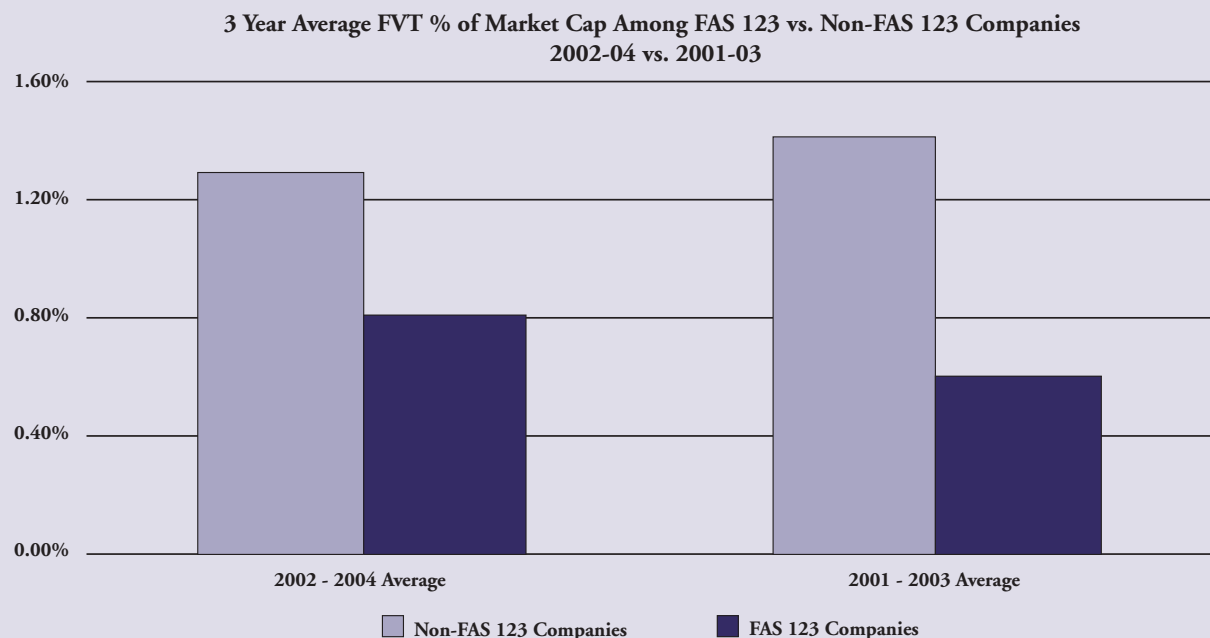
FVT % OF MARKET CAPITALIZATION – FAS 123 VS. NON-FAS 123 COMPANIES

As demonstrated in the chart below, companies that have adopted FAS 123 are granting less long-term incentive value in the aggregate than those that have not

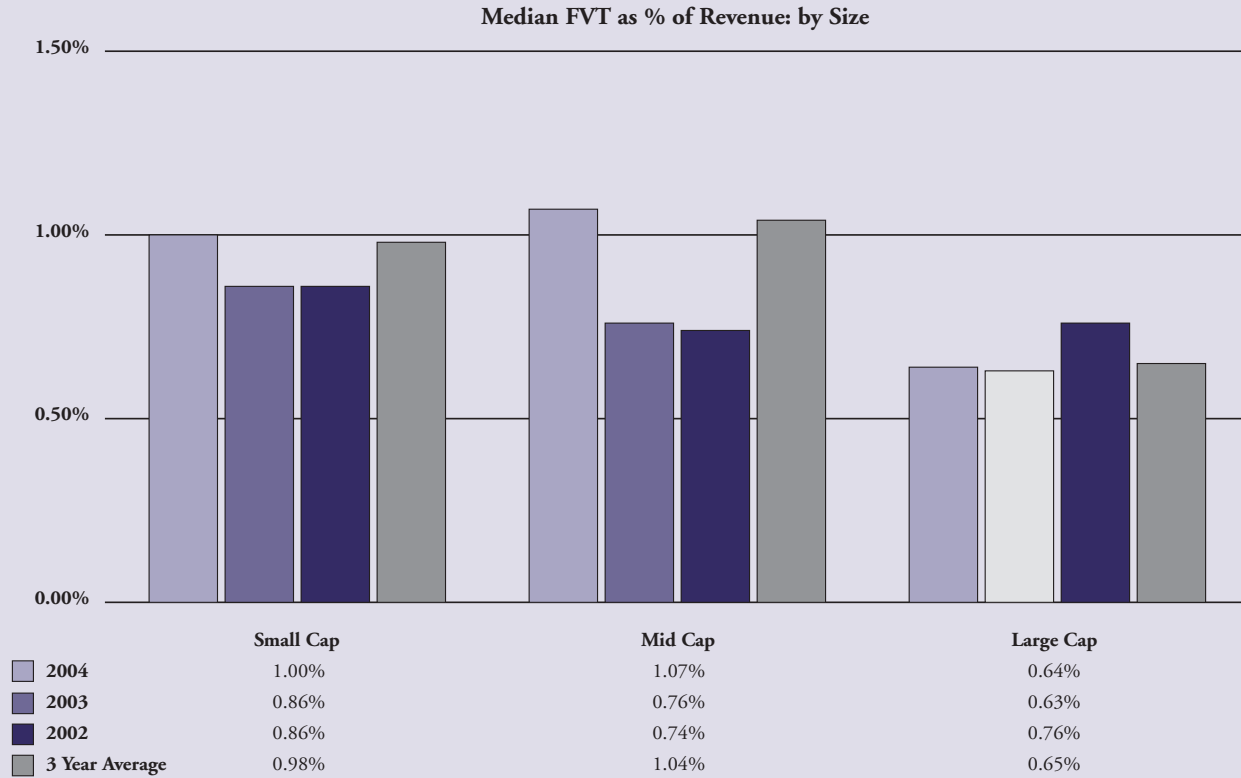


FVT % OF MARKET CAPITALIZATION – FAS 123 VS. NON-FAS 123 COMPANIES

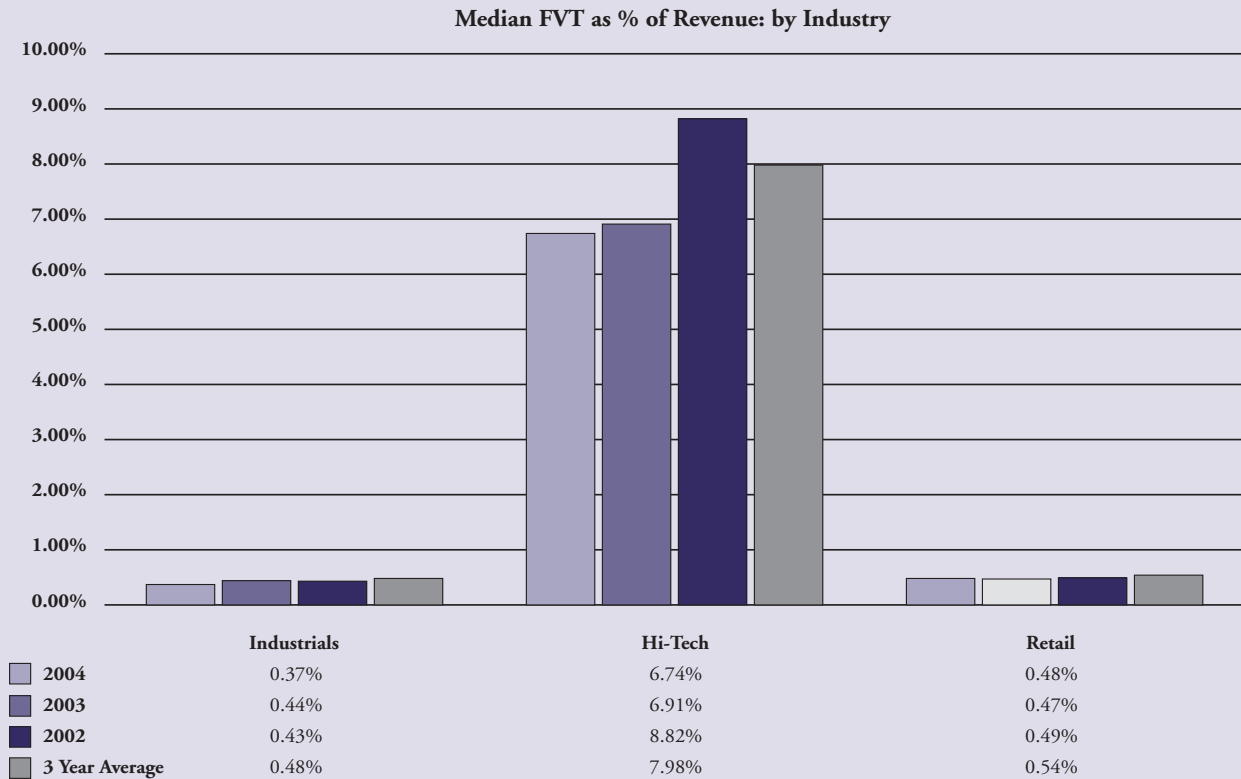
Shown below is the trend of FAS 123 vs. Non-FAS 123 companies compared to last year's report. The increase in 2004 FAS 123 companies' FVT granted is likely due to more companies opting to expense stock options before the deadline.



OTHER FINANCIAL MEASURES: MEDIAN FVT % OF REVENUE – BY SIZE



OTHER FINANCIAL MEASURES: MEDIAN FVT % OF REVENUE – BY INDUSTRY

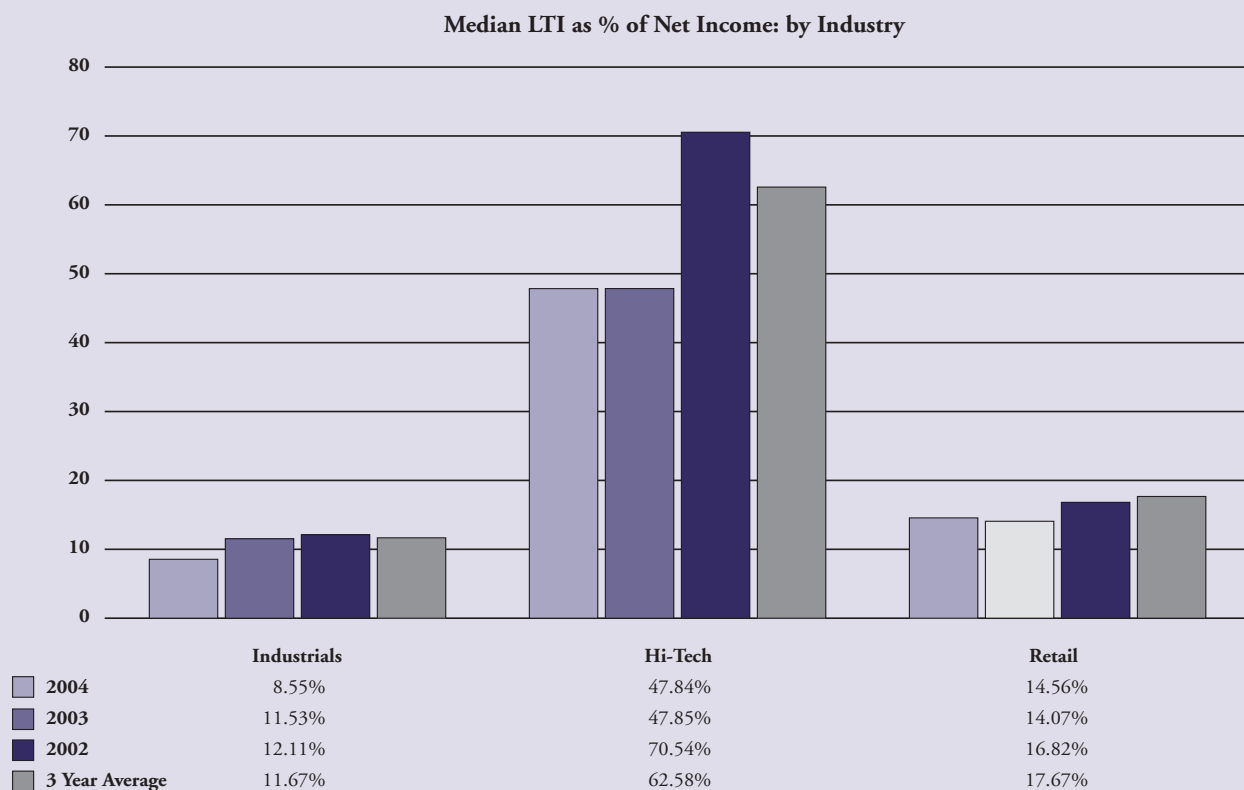


SUMMARY FINDINGS

OTHER FINANCIAL MEASURES: MEDIAN FVT % OF NET INCOME – BY SIZE



OTHER FINANCIAL MEASURES: MEDIAN FVT % OF NET INCOME – BY INDUSTRY



3M CO	COST PLUS	KEANE	SAKS
ABERCROMBIE & FITCH	COSTAR GROUP	KOHL'S	SERENA SOFTWARE
ABM INDUSTRIES	COSTCO WHOLESALE	KROGER CO	SHARPER IMAGE
ADOBE SYSTEMS	DEERE & CO	KRONOS	SHERWIN-WILLIAMS
ADVANCE AUTO PARTS	DELL	LIMITED BRANDS	SHOPKO STORES
AGILYSYS	DIODES	LINDSAY	SIEBEL SYSTEMS
ALADDIN KNOWLEDGE SYSTEMS	DOLLAR THRIFTY AUTOMOTIVE	MANUFACTURING	SMART & FINAL
ALASKA AIR GROUP	R.R. DONNELLEY & SONS	LINENS N THINGS	SOHU.COM
ALBERTSONS	DOVER	MACROMEDIA	SONIC AUTOMOTIVE
AMDOCS	EATON	MAY DEPARTMENT STORES	SOUTHWEST AIRLINES
AMERICAN STANDARD COMPANIES	ECOLLEGE.COM	MENS WEARHOUSE	SPORTS AUTHORITY
AMERICAN WOODMARK	EGL	MERCURY INTERACTIVE	SUNGARD DATA SYSTEMS
ANN TAYLOR STORES	ELECTRONIC ARTS	MESA AIR GROUP	SUPERVALU
APPLE COMPUTER	EMERSON ELECTRIC	MICROMUSE	SYBASE
APPLIED MATERIALS	EXPRESSJET HOLDINGS	MICROSEMI	SYMANTEC
ARAMARK	FEDERAL SIGNAL	HERMAN MILLER	SYNOSSYS
ARIBA	FEDERATED DEPT STORES	MIVA	TALX
ARMOR HOLDINGS	FEDEX	MOOG	TARGET
ASK JEEVES	FINISH LINE	MOVADO GROUP	TELEDYNE
ATARI	FOOT LOCKER	MYKROLIS	TECHNOLOGIES
AUTOBYTEL	FRONTIER AIRLINES	NACCO INDUSTRIES	TEXAS INSTRUMENTS
AUTODESK	GAP	NAVISTAR	TEXTRON
AUTOZONE	GENERAL ELECTRIC	INTERNATIONAL	TIBCO SOFTWARE
BARNES & NOBLE	GLOBAL POWER EQUIPMENT	NCI BUILDING SYSTEMS	TJX COMPANIES
BEA SYSTEMS	GUESS	NEIMAN-MARCUS GROUP	TOO
BED BATH & BEYOND	GUITAR CENTER	NORDSTROM	TORO COMPANY
BEST BUY	GYMBOREE	NORFOLK SOUTHERN	TOYS R US
BOEING	HEARTLAND EXPRESS	OFFICE DEPOT	TREX COMPANY
BOMBAY COMPANY	HEWLETT-PACKARD	OLD DOMINION FREIGHT	TRIUMPH GROUP
BORDERS GROUP	HIBBETT SPORTING GOODS	OPEN TEXT	UNITED PARCEL SERVICE
BRINKS	HOME DEPOT	ORACLE	UNITED STATIONERS
BROOKSTONE	HONEYWELL INTERNATIONAL	OSHKOSH TRUCK	URBAN OUTFITTERS
BURLINGTON NORTHERN SANTA FE	IDEX	PENTAIR	USA TRUCK
CACHE	ILLINOIS TOOL WORKS	PEP BOYS	VALMONT INDUSTRIES
CARLISLE	INFORMATICA	PETSMART	VALUECLICK
CARMAX	INFOSPACE	PIER 1 IMPORTS	VERISIGN
CATERPILLAR	INTEGRATED DEVICE TECH	PITNEY BOWES	VERITAS SOFTWARE
CHILDRENS PLACE RETAIL STORES	INTERNATIONAL RECTIFIER	PROGRESS SOFTWARE	VERITY
CIBER	INTUIT	QUALCOMM	WAL-MART STORES
CISCO SYSTEMS	JETBLUE AIRWAYS	QUEST SOFTWARE	WEBEX
CITRIX SYSTEMS	JLG INDUSTRIES	RADIOSHACK	COMMUNICATIONS
CNF	JO-ANN STORES	RAMBUS	WEBSense
COMPUTER ASSOCIATES	JOS A BANK CLOTHIERS	RED HAT	WHOLE FOODS MARKET
CONTINENTAL AIRLINES	JOY GLOBAL	RELIANCE STEEL & ALUMINUM	WILD OATS MARKETS
COOPER INDUSTRIES		RESEARCH IN MOTION	WILLIAMS-SONOMA
		RESTORATION HARDWARE	YAHOO
		RUDOLPH TECHNOLOGIES	ZALE
		RYDER SYSTEM	

COMPANY PROFILE

Frederic W. Cook & Co., Inc. is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, our firm has served more than 1,700 corporations, including 40 percent of the current Fortune 200 during the past two years, in a wide variety of industries from our offices in New York, Chicago, Los Angeles, and San Francisco. Our primary focus is on performance-based compensation programs that help companies attract and retain business leaders, motivate and reward them for improved performance, and align their interests with shareholders. Our range of consulting services includes:

- Annual Incentive Plans
- Change-in-Control and Severance
- Compensation Committee Advisor
- Competitive Assessment
- Corporate Governance Matters
- Corporate Transactions
- Directors' Remuneration
- Incentive Grants and Guidelines
- Long-term Incentive Design
- Ownership Programs
- Performance Measurement
- Recruitment/Retention Incentives
- Regulatory Services
- Restructuring Incentives
- Shareholder Voting Matters
- Specific Plan Reviews
- Strategic Incentives
- Total Compensation Reviews

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