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New York • Chicago • Los Angeles

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UPDATE ON STOCK OPTION ACCOUNTING DEBATE

The July 14 announcement by Coca-Cola and subsequent action taken by several other prominent companies to begin expensing the cost of stock options may be one of the most significant developments affecting executive compensation in the last several years.

This letter provides background on the "stock option accounting" issue, a summary of the ongoing debate, and the possible impact on publicly-traded U.S. companies.

BACKGROUND

Under generally accepted accounting principles (GAAP), U.S. companies are currently permitted to choose whether P&L expense attributable to stock options is determined under APB Opinion 25 or FAS Statement 123.

There is generally no expense recognition required under Opinion 25, assuming that the option exercise price equals or exceeds the fair market value of the underlying stock on the grant date and that vesting is contingent only on the passage of time. Conversely, FAS 123 results in expense equal to the fair value of the option as of the measurement date. Fair value is generally determined using an option pricing model (e.g., Black-Scholes, binomial) and the measurement date is generally defined as the grant date.[1]

If a company elects to use Opinion 25 methodology, GAAP rules require disclosure of the pro forma impact under FAS 123 as a footnote to the annual report. If a Company formally adopts FAS 123, the decision applies to all of its equity compensation awards and is irrevocable.

CURRENT DEBATE

For a variety of reasons, virtually all U.S. companies have historically elected Opinion 25 rather than FAS 123 treatment of stock options.[2]

There is a growing public perception that stock options and their accounting treatment under Opinion 25 contributed to the speculative bubble in stock prices and recent

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[1] Note that Coca-Cola has announced that they will use the average of quotes provided by two investment banks to determine the value of options. Presumably, these banks will use the Black-Scholes Model or a derivative to determine their quotes.

[2] Prior to the announcement by Coca-Cola on July 14, the only other major companies using the FAS 123 standard were Boeing and Winn Dixie Stores.

corporate debacles such as Enron, Global Crossing, and WorldCom. The primary criticisms include:

- The absence of a P&L charge leads to increasingly large option grants, excessive shareholder dilution, and a general lack of accountability among management and the Board for the "cost" of such grants

- The absence of a P&L charge results in overstatement of earnings, since economically equivalent awards delivered in some other form would require the recording of an expense

- Large option grants create excessive short-term focus on stock price, which leads to misalignment between management and shareholder interests. In extreme cases, this may encourage management to falsify financial reporting to support the stock price

As a result of these criticisms, there is an intense debate about whether the current GAAP accounting standards should be modified to require an earnings charge. Defenders of the current accounting treatment generally argue that:

- Options are not a company expense, but rather are a cost incurred by shareholders in the form of dilution. As such, costs are reflected in the form of lower earnings per share, which can be measured as the difference between basic and diluted EPS

- Option pricing models (e.g., the Black-Scholes Model, the binomial model) are inaccurate in their ability to predict the values of employee stock options, which generally have long terms, vesting restrictions, and are non-transferable

The following table summarizes the positions of some of the most influential and vocal constituencies involved in this debate:

For a P&L Charge	***Against a P&L Charge***
• Alan Greenspan • Former SEC Chair A. Levitt • Senator J. McCain • Warren Buffet • The US Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB) • Most institutional investors, including the Council of Institutional Investors	• President Bush • SEC Chair H. Pitt • Senator J. Lieberman • Many publicly listed companies, particularly those in high tech

In addition to the above, there are a growing number of financial analysts who favor an accounting charge and are beginning to consider the FAS 123 footnote disclosure in formulating their recommendations regarding stocks. In an attempt to improve the reliability of reported earnings, Standard & Poor's recently announced that they will include the FAS 123 reported cost of stock options in formulating "core earnings," irrespective of whether a Company formally adopts FAS 123. Core earnings is S&P's assessment of the after-tax value of earnings generated from a company's principal businesses, and will become part of S&P's debt-rating activities.

It should also be noted that many investors view the stock option accounting issue as both a financial reporting and a corporate governance challenge. The 2002 Global Investor Opinion Survey recently released by McKinsey & Company indicates that North American investors are willing to pay an average premium of 12% to 14% for a well governed company, and that investors are unified regarding the expensing of stock options in P&L statements (over 80% support such a charge on a global basis).

POSSIBLE IMPLICATIONS

On July 11, a proposal was defeated in the Senate that would have required the expensing of stock options. As a result, it seems unlikely that there will be a *mandated* change in accounting policy in the immediate future.

However, on July 16, the International Accounting Standards Board unanimously approved staff recommendations to require the expensing of all equity compensation awards as the fair value at grant date (i.e., a FAS 123-like standard). The IASB includes the former vice chairman of the U.S. Financial Accounting Standards Board, who has indicated that the U.S. will play a leading role in adoption of global accounting standards. In addition, the newly appointed chairman of the FASB is a former member of the IASB.

Irrespective of whether mandated change is likely in the short-term, investor perceptions regarding stock options and their "cost" raise the importance of maintaining a well planned and executed long-term incentive strategy. Some of the factors likely to affect all companies are discussed below.

Possible Trend Toward Expensing

The announcement by Coca-Cola that it would begin expensing the cost of stock options may create a trend among companies with similar characteristics. Development of such a trend would create pressure for others to follow and lend support to government or FASB initiatives to require expensing.

Companies most likely to voluntarily elect FAS 123 would include those with a large asset base within a capital intensive, high profile business. These are companies with mature product lines and substantial cash flow, and generally have relatively low "run rate" attributable to ongoing stock incentive awards and a reasonably low stock price volatility.[3] These companies are also likely to already be delivering or intend to deliver a large portion of future compensation in the form of full value awards (e.g., restricted stock, performance shares, etc.) that already require expensing under Opinion 25.

In the short time since Coca-Cola's announcement, other companies have indicated that they will expense stock options, including The Washington Post, Bank One, Valley National Bancorp, Dole Food, Sovereign Bancorp, Fannie Mae, Freddie Mac, The Scotts Company, Cinergy Corp., Wachovia Corp., Neuberger Berman, Webster Financial, MBIA, Computer Associates, and Amazon.com. Earlier, AMB Property Corp had announced that it intends to expense stock options, which was followed by iStar Financial (both real estate investment trusts). With the exception of Amazon and Computer Associates, all of these companies fit the above description.

Companies most likely to resist a developing trend would include high tech start-ups and other people-intensive businesses in which stock price volatility is high, cash is in short supply, and the pressure to make large option awards is substantial. These characteristics make the "cost" much more significant on a relative basis. In its press release announcing adoption of FAS 123, Amazon mentioned that it would continue to provide "pro forma" earnings releases in addition to bottom line results. The pro forma results, which focus on cash flows, will exclude the charge applicable to stock options.

Pressure from Institutional Investors

Irrespective of the true cost of options, high levels of perceived cost result in negative votes from shareholders on proposals to replenish the share reserve in equity compensation plans.

Shareholders are making rapid gains in their ability to influence share dilution levels. Recently released SEC rules require annual disclosure of all equity compensation plans, including those that are approved by shareholders as well as those that are not. In addition, proposed rule changes at the New York Stock Exchange would require shareholder approval of all equity compensation plans, and a similar proposal at the Nasdaq would require shareholder approval of any plan in which officers and directors could participate. President Bush recently endorsed these proposals publicly, and we understand that the SEC is encouraging both markets to adopt the new rules quickly.[4]

On July 24, TIAA-CREF announced a widespread initiative in which it would actively lobby the chairmen of over 1,750 major public companies in which they hold a major investment position to begin expensing options. The Council of Institutional Investors, which represents over 130 pension funds, also indicated a desire to initiate a similar campaign.

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[3] Run rate is defined as annual shares granted in employee equity plans divided by total outstanding common shares.

[4] Note that it is not yet clear whether the Nasdaq will adopt the more stringent requirement proposed by the NYSE. However, there is clearly pressure to do so.

Investor Scrutiny

Financial analysts are increasingly including overhang[5] and FAS 123 reported costs when developing their buy and sell recommendations. Further, high costs from stock options will reduce S&P's "core earnings" estimate.

The FAS 123 footnote is readily available to investors, and even though reported results are not universally accepted as accurate, they allow for analysis of "cost" on a relative basis versus industry peers. During the bull market of the 1990s, it is safe to say that little thought was given to the footnote disclosures regarding stock option expense. In today's environment, however, companies with high "costs" are viewed less favorably than those with lower "costs."

HOW TO RESPOND

Despite some negative media attention involving the role stock options may have played in various corporate scandals, one thing is clear – ***options have historically been and will continue to be a powerful tool in aligning the interests of management with those of shareholders.***

Notwithstanding the above, changes to investor perceptions and the possibility of a change in accounting treatment have diminished the historic advantage in financial efficiency once associated with stock options. In other words, while options may still be more financially efficient than cash-based or full-value equity grants, the perception of cost or the actual charge to earnings associated with FAS 123 treatment makes them less so.

As a result, the "cost" of a company's stock option program and the related plan design implications with regard to overall long-term incentives is an issue that needs careful attention.

Here are some thoughts on actions that can be taken now:

1. Examine the impact of adopting the FAS 123 accounting standard for future stock incentive awards

    — What impact would this have on reported EPS?

    — Are there elements of the existing stock option program that should be re-examined under such a standard?

        -- For example, the financial efficiency of reload stock options would be impaired under a FAS 123 standard. If you make such grants or are considering doing so, how would this issue best be addressed?

[5] Overhang is the potential share dilution attributable to outstanding equity compensation awards.

-- Also, there would be no relative financial penalty for true performance-based vesting schedules and/or indexing of the option's exercise price. Would these performance improvements, which may enhance the public's perceptions of a company's governance standards, offset some of the negatives associated with the earnings charge? Indeed, if you are planning on adopting performance-based option grants anyway, and there is growing pressure on all companies to do so, the cost may be lower under FAS 123 than under Opinion 25

2. Discuss the issue with industry peers and advisors to assess the likelihood of a trend developing within your industry

— If such a trend develops, is it likely that it could be resisted? If not, does it make sense from a governance perspective to be at the forefront of such a change?

3. Consider whether changes would be appropriate in the overall long-term incentive program if stock options were to be expensed

— As the financial efficiency of stock options relative to other forms of incentives diminishes, it becomes relatively less costly to deliver a portion of the LTI opportunity in cash or full-value equity grants

— Does it make sense to reconsider the mix of long-term incentives? If you currently deliver the entire LTI opportunity through stock options, is it sensible to consider replacing a portion of the option grant with a cash- or stock-based plan?

-- When properly designed, "non-option" LTI plans can enhance the retentive impact of the overall compensation program, encourage greater focus on long-term operational performance objectives, reduce overall exposure to stock price risk and therefore create better balance in long-term executive wealth creation opportunities, and enhance the commonality of interests between management and shareholders

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions about this letter may be addressed to Daniel Ryterband in our New York office at 212.986.6330 or by email at djryterband@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.