

FREDERIC W. COOK & CO., INC.

# FVAT

## FAIR VALUE TRANSFER

*Alternative Approach to  
Measuring Aggregate Long-Term  
Incentive Grant Values*

FEBRUARY 2005

Long-term incentive (LTI) compensation programs at public companies are in a state of flux. Companies have already started rethinking LTI compensation strategy in response to regulatory changes, shareholder pressures to constrain dilution, and market volatility over the past few years. But, the transformation has only just begun.

Perhaps the strongest driver of future change will be the new accounting rules for stock-based compensation issued by the Financial Accounting Standards Board (FASB) in December 2004. These rules, which go into effect for public companies' reporting periods beginning after June 15, 2005, require companies to record an expense on the income statement for stock options. With options no longer "free," companies will be forced to evaluate LTI programs not only in terms of traditional share usage and dilution considerations, but also from the perspective of overall affordability.

### **ALTERNATIVE MEASURE OF ANNUAL LTI COMPENSATION "USAGE"**

Traditional methods for comparing the relative magnitude of aggregate LTI grant values across companies are becoming less relevant. The first such traditional method, commonly referred to as "run rate," is annual share usage measured as a percentage of outstanding company shares. The second is "overhang," which is the number of shares represented by outstanding grants and available authorizations as a percentage of total outstanding company shares.

Why are these widely used reference points losing their relevance? The answer is that they count all shares granted as being alike, regardless of grant type, when we know this is not the case in terms of grant value, accounting costs, and real dilution.

The traditional methods worked when the vast majority of LTI grants were in the form of stock options. However, companies have shifted from options-only programs to a more balanced mix of grant types, such that a significant portion of grant value is now in the form of full-value shares such as restricted and performance stock.

For example, a company can easily decrease its run rate by granting one share of restricted stock for every two options it granted in the prior year. But, if the option value for expense purposes is 25% of the share price at grant, then four options are equivalent to one full-value share in grant value and expense under FASB's new equity compensation accounting rules. Although the company's run rate would be cut in half, compensation expense would double (assuming a relatively constant share price) and real dilution would increase.

An alternative way to measure annual LTI compensation usage in this environment is in terms of fair value transfer (FVT), which measures the aggregate annual grant value/cost of LTI compensation awards.

#### **FVT grant value:**

- Provides a measure of aggregate pre-tax compensation cost of grants made in a given year (which cost will likely be spread over multiple future years for profit and loss purposes).
- Facilitates appropriate 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. That is, the method recognizes that an option has less immediate dilution than a full-value share.

## INTRODUCTION

### **FVT as a percentage of market capitalization:**

- Allows comparisons to be made across companies to assess the competitiveness and reasonableness of a given company's aggregate grant budget.
- Eliminates distortion from stock price fluctuations on share usage, especially for companies that establish grant guidelines based on competitive LTI values.
- Is consistent with the way investor advisory groups, such as Institutional Shareholder Services (ISS), assess the reasonableness of company aggregate grant practices.
  - ISS recognized the issues associated with traditional measures of potential dilution some time ago, and switched its primary methodology for evaluating the reasonableness of share authorization requests from traditional potential dilution to Shareholder Value Transfer (SVT), which measures outstanding and potential grant value as a percentage of company market capitalization. Traditional “overhang” is still a factor in their calculations, but the SVT calculation is weighted much more heavily. (Although similar to ISS' SVT calculation, our FVT calculation uses a different methodology and focuses on annual usage as opposed to total potential dilution.)
  - In theory, what ISS measures is the portion of the company's market value that can potentially be transferred to executives and employees through LTI grants. More significantly, though, the ISS methodology infers that investors regard company market-cap value as a relevant reference point for comparing grant values (and costs) across companies.

This report marks the first edition of Frederic W. Cook & Co.'s research on FVT practices in public companies. Our research analyzes three-year historical FVT for 180 companies of various size and industry categories. In the pages that follow, we present a detailed explanation of our research methodology, along with key findings from the study.

## RESEARCH SAMPLE

To identify patterns in FVT usage among companies of different sizes and industry sectors, we selected 180 companies categorized as follows:

	<b>Small Cap</b> (Mkt. Cap. <\$1B)	<b>Mid Cap</b> (Mkt. Cap. between \$1B and \$5B)	<b>Large Cap</b> (Mkt. Cap. >\$5B)	<b>Total</b>
<b>Industrial</b>	20	20	20	<b>60</b>
<b>Retail</b>	20	20	20	<b>60</b>
<b>Hi-Tech</b>	20	20	20	<b>60</b>
<b>Total</b>	<b>60</b>	<b>60</b>	<b>60</b>	<b>180</b>

Industry categorization is based on Standard & Poor's Global Industry Classification Standard (GICS) Economic Sector and Industry Group codes. Each company in the sample set is publicly traded and provided three-year historical disclosure on equity compensation in SEC filings.

Market capitalizations and trailing four quarters revenues as of December 31, 2004, break down as follows:

	<b>Market Capitalization (\$mil.)</b> <i>as of 12/31/04</i>			<b>Trailing 4 Qtrs. Revenue (\$mil.)</b> <i>as of 12/31/04</i>			<b>Market Cap. As Multiple of Revenue</b>		
	<b>25P</b>	<b>Med</b>	<b>75P</b>	<b>25P</b>	<b>Med</b>	<b>75P</b>	<b>25P</b>	<b>Med</b>	<b>75P</b>
<b>Size Categories</b>									
<b>Small</b>	\$ 440	\$ 700	\$ 887	\$ 194	\$ 622	\$ 1,310	2.3	1.1	0.7
<b>Mid</b>	\$ 1,551	\$ 2,261	\$ 3,509	\$ 672	\$ 1,855	\$ 3,770	2.3	1.2	0.9
<b>Large</b>	\$ 9,673	\$16,582	\$41,728	\$ 5,193	\$10,870	\$27,595	1.9	1.5	1.5
<b>Industry Sectors</b>									
<b>Industrial</b>	\$ 900	\$ 2,144	\$10,277	\$ 1,191	\$ 2,685	\$ 9,269	0.8	0.8	1.1
<b>Retail</b>	\$ 873	\$ 3,221	\$ 7,598	\$ 1,493	\$ 3,678	\$11,196	0.6	0.9	0.7
<b>Hi-Tech</b>	\$ 898	\$ 2,033	\$12,755	\$ 175	\$ 398	\$ 1,911	5.1	5.1	6.7
<b>Total Sample</b>	\$ 896	\$ 2,261	\$ 9,462	\$ 647	\$ 2,097	\$ 7,062	1.4	1.1	1.3

The selected companies are identified on the Exhibit on page 11.

## CALCULATION OF FAIR VALUE TRANSFER (FVT)

FVT measures the pre-tax “fair value” of equity awards granted during the year. For the purposes of this research report, pre-tax fair value of equity awards is calculated for the most recent three years available, using the stock-based compensation footnote disclosures in each company’s Form 10-K, supplemented by information from the proxy statement.

Fair value is calculated as follows:

- Options are valued using the weighted average fair value of options granted during the year. If such a fair value was not disclosed in the public filings, it was calculated using the binomial option pricing model and the input assumptions reported by that particular company.
- Restricted shares are valued at 100% of share price at the time of grant.<sup>1</sup>
- Performance shares are valued using the target number of shares at 100% of share price at the time of grant.<sup>1</sup>
- Cash-based LTI awards are valued at grant-date target value.<sup>1</sup>

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.

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

The table below provides an example calculation:

Company Market Capitalization (\$mil.)	\$2,000
Weighted Average Shares Outstanding (mil.)	40
Number of 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 (\$mil.)</i>	<i>\$15</i>
Number of Restricted Shares Granted	100,000
Weighted Average Grant Price	\$50.00
<i>Aggregate Pre-Tax R.S. Fair Value (\$mil.)</i>	<i>\$5</i>
<b><i>FVT (\$millions)</i></b>	<b><i>\$20</i></b>
<b><i>FVT (% of Market Cap)</i></b>	<b><i>1.00%</i></b>

<sup>1</sup> 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 as disclosed in proxy statements were used, under the assumption that the top executives receive the majority of these types of awards.

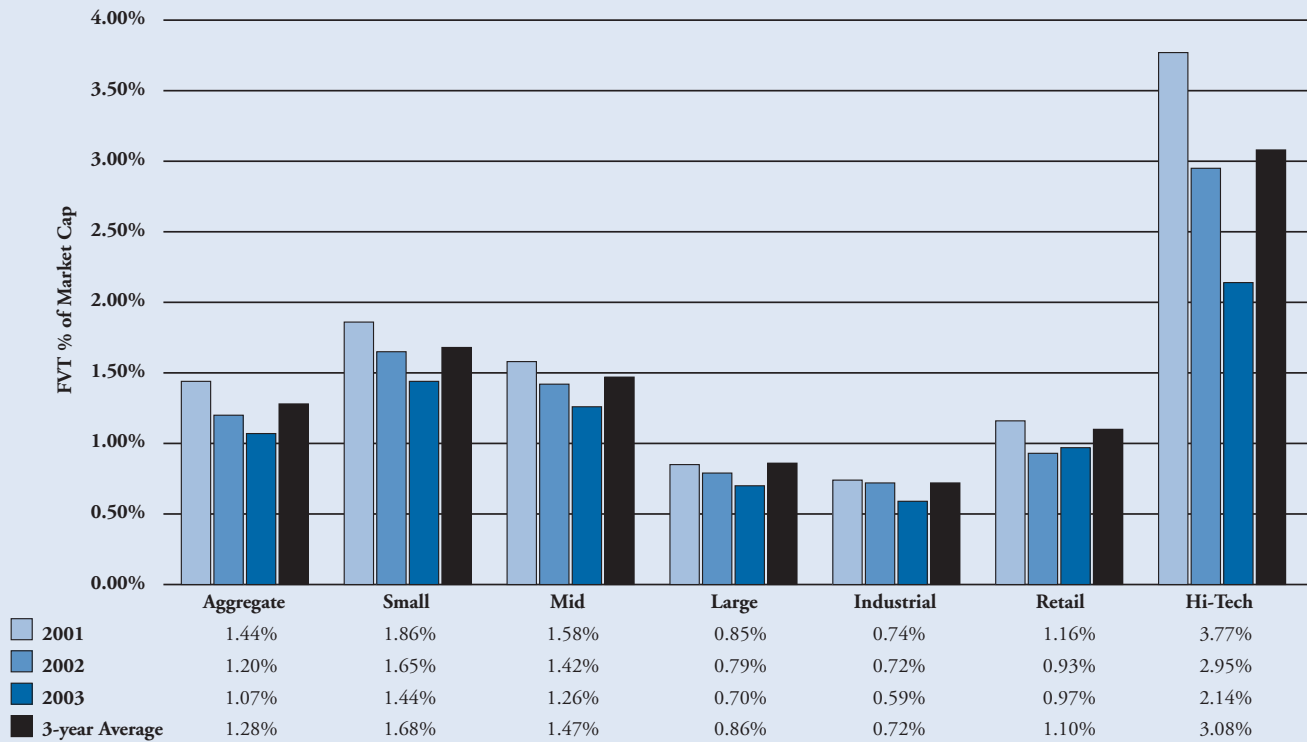
## MEDIAN FVT

The following charts summarize median historical FVT as a percentage of weighted average market capitalization, in the aggregate, and for various subsets of companies. As a secondary comparison, we also provide charts of FVT as a percentage of annual revenue. These data illustrate the following:

- FVT as a percentage of both market capitalization and revenue has declined from 2001 to 2003, indicating a curtailment of LTI compensation.
  - Traditional run rates (shares granted as a percentage of total shares outstanding) have followed generally the same pattern of decline.
  - The median aggregate FVT dollar value decreased from 2001 to 2003 (with an increase from 2001 to 2002). However, the overall percentage decrease was not as great as the percentage decrease in traditional run rate and FVT as a percentage of market capitalization. This is likely due in part to the increase in median market capitalization from 2001 to 2003, which generally causes each option or full-value share granted to have greater value and cost.
- There is a negative correlation between company size and aggregate FVT as a percentage of market capitalization, which supports the logic that smaller companies require a greater percentage of total market capitalization than larger companies to deliver competitive compensation opportunities.
  - The correlation is weaker when comparing aggregate FVT as a percentage of revenue, however.
- Hi-Tech companies had significantly higher FVT, both as a percentage of market capitalization and as a percentage of revenue, than the other industry classifications. Retail companies had higher FVT percentages than Industrial companies.
  - It would be expected that human capital-intensive companies, such as Hi-Tech companies and to a lesser extent Retail companies, would need larger aggregate LTI grant budgets.
- Additional detail is presented in the Appendix.

# FINDINGS

**CHART A: MEDIAN HISTORICAL FVT AS A PERCENTAGE OF MARKET CAPITALIZATION**



**CHART B: 3-YEAR MEDIAN HISTORICAL FVT AS A PERCENTAGE OF MARKET CAPITALIZATION – FURTHER DETAIL**

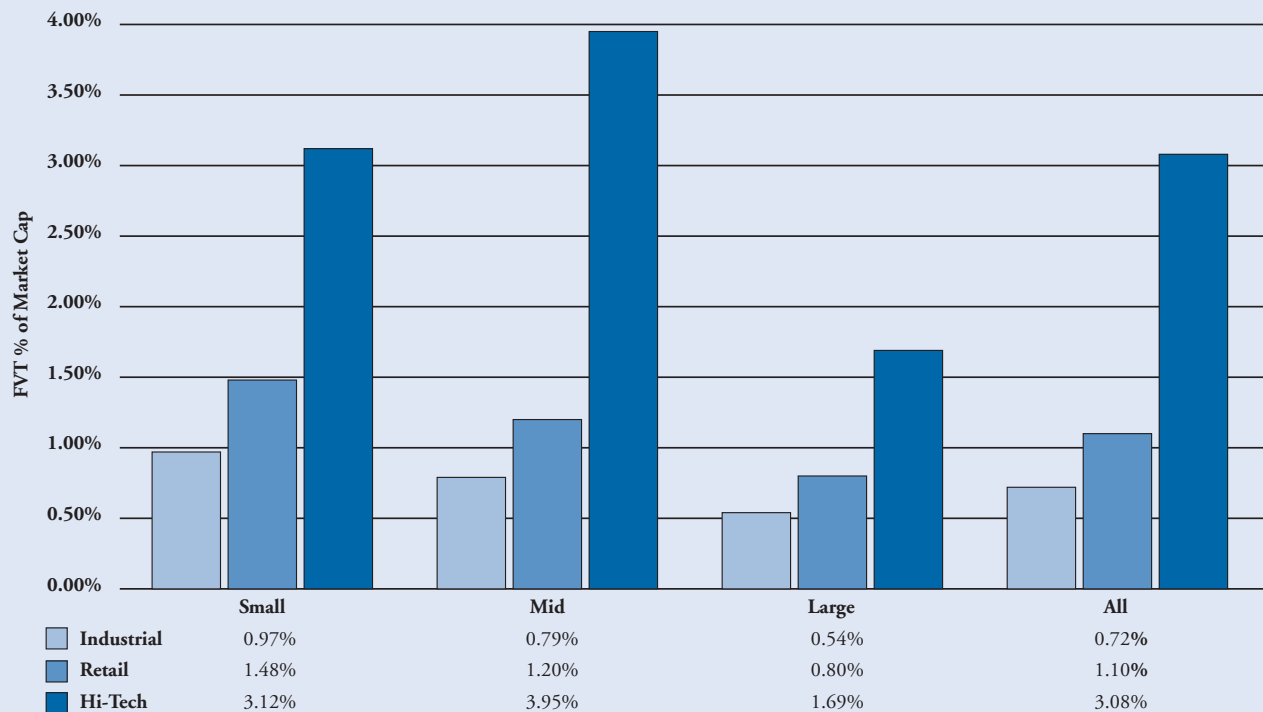


CHART C: MEDIAN HISTORICAL FVT AS A PERCENTAGE OF REVENUE

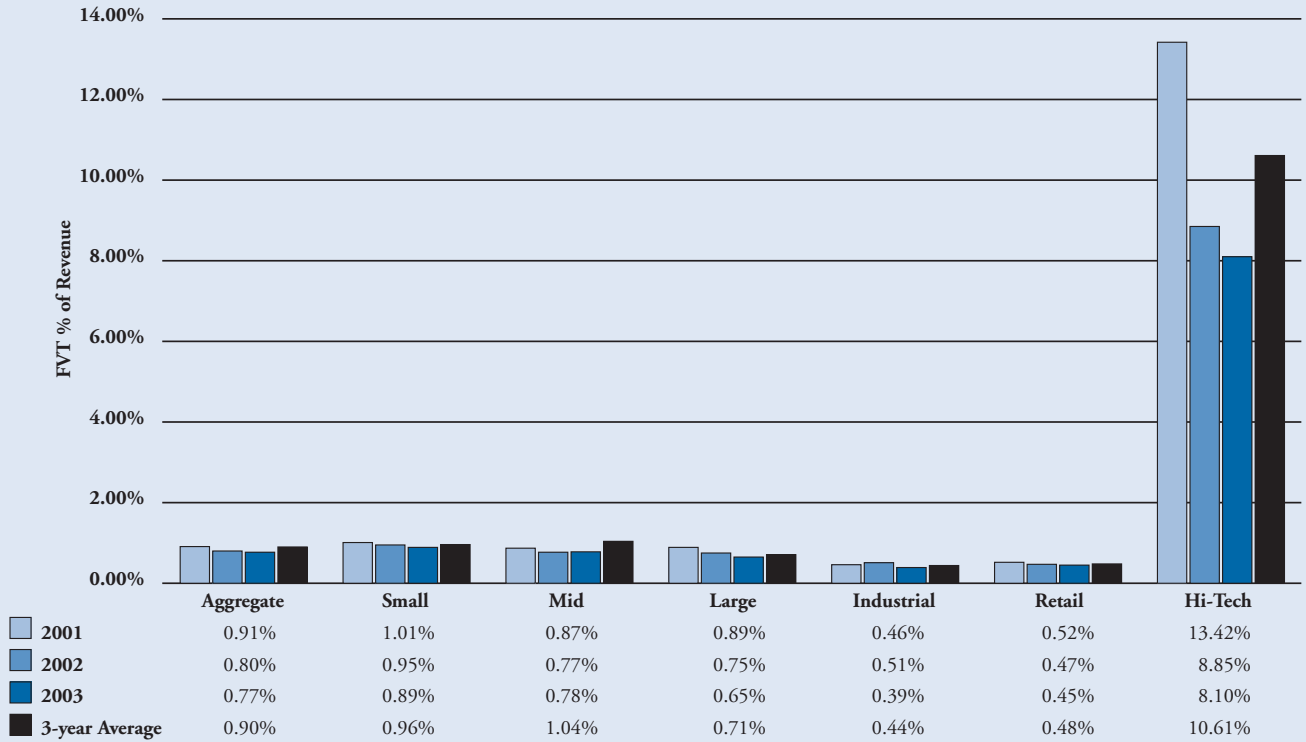
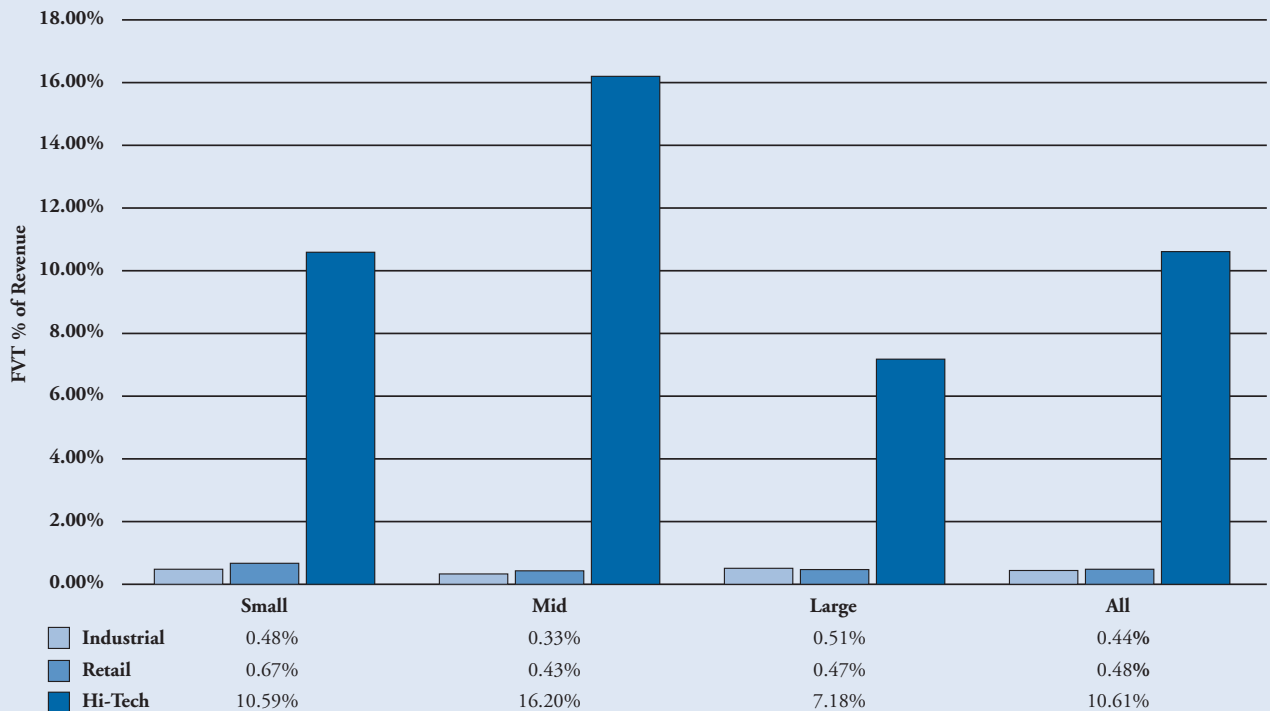


CHART D: 3-YEAR MEDIAN HISTORICAL FVT AS A PERCENTAGE OF REVENUE – FURTHER DETAIL

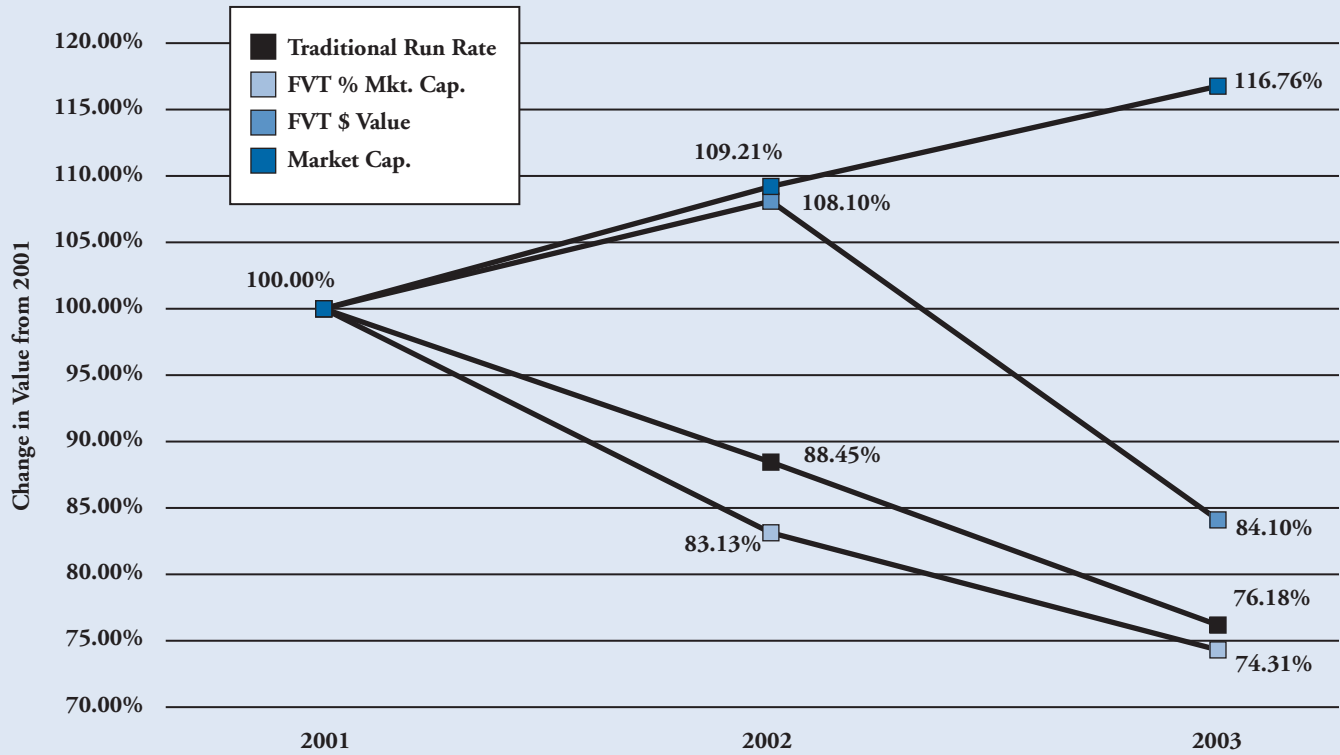




## FINDINGS

### CHART E: 3-YEAR HISTORICAL TREND ANALYSIS – CHANGE IN AGGREGATE SAMPLE MEDIANS FROM 2001 - 2003

(Statistics indexed to 2001 values, i.e., 2001 = 100%)



With option expensing imminent, companies must begin to think about LTI compensation differently than they have in the past. As companies continue to change grant practices and introduce other grant types in addition to stock options to their LTI mixes, it is time to change the focus from traditional methods of comparing LTI grants in terms of simple numbers of shares to examining relative aggregate grant values that take into account the differences between options and full-value shares.

Measuring FVT, both on an absolute basis and as percentages of market capitalization, can help companies assess the affordability, competitiveness, and reasonableness of proposed LTI programs. Analyzing FVT as a percentage of market capitalization provides a meaningful basis for comparison across companies, and is currently used by institutional investor advisory groups, such as ISS. Whether or not market capitalization becomes the standard for relative grant value and cost comparisons remains to be seen. Other possible measures that could emerge are company revenue, enterprise value, operating expenses, etc.

## APPENDIX

	3-Year Avg. FVT % Mkt. Cap.			2003 FVT % Mkt. Cap.			2002 FVT % Mkt. Cap.			2001 FVT % Mkt. Cap.		
	25P	Med	75P	25P	Med	75P	25P	Med	75P	25P	Med	75P
	<i>Size Categories</i>											
<b>Small</b>	0.97%	1.68%	2.80%	0.74%	1.44%	2.63%	0.91%	1.65%	2.94%	0.84%	1.86%	3.09%
<b>Mid</b>	0.84%	1.47%	3.09%	0.68%	1.26%	2.06%	0.69%	1.42%	3.19%	0.93%	1.58%	4.03%
<b>Large</b>	0.51%	0.86%	1.51%	0.43%	0.70%	1.15%	0.48%	0.79%	1.30%	0.46%	0.85%	1.80%
<i>Industry Sectors</i>												
<b>Industrial</b>	0.51%	0.72%	0.98%	0.39%	0.59%	0.86%	0.43%	0.72%	1.22%	0.40%	0.74%	1.17%
<b>Retail</b>	0.77%	1.10%	1.55%	0.62%	0.97%	1.33%	0.58%	0.93%	1.44%	0.69%	1.16%	2.02%
<b>Hi-Tech</b>	1.94%	3.08%	4.56%	1.53%	2.14%	3.08%	1.92%	2.95%	4.30%	2.07%	3.77%	5.82%
<b>Total Sample</b>	0.73%	1.28%	2.50%	0.59%	1.07%	1.90%	0.60%	1.20%	2.61%	0.68%	1.44%	2.78%

	3-Year Avg. FVT % of Revenue			2003 FVT % of Revenue			2002 FVT % of Revenue			2001 FVT % of Revenue		
	25P	Med	75P	25P	Med	75P	25P	Med	75P	25P	Med	75P
	<i>Size Categories</i>											
<b>Small</b>	0.44%	0.96%	6.58%	0.38%	0.89%	7.10%	0.43%	0.95%	6.07%	0.41%	1.01%	5.96%
<b>Mid</b>	0.35%	1.04%	9.62%	0.28%	0.78%	5.79%	0.36%	0.77%	8.44%	0.29%	0.87%	13.02%
<b>Large</b>	0.41%	0.71%	5.98%	0.32%	0.65%	2.31%	0.40%	0.75%	3.65%	0.46%	0.89%	6.78%
<i>Industry Sectors</i>												
<b>Industrial</b>	0.31%	0.44%	0.80%	0.21%	0.39%	0.72%	0.34%	0.51%	0.90%	0.27%	0.46%	0.77%
<b>Retail</b>	0.31%	0.48%	0.97%	0.23%	0.45%	0.90%	0.35%	0.47%	0.75%	0.28%	0.52%	0.96%
<b>Hi-Tech</b>	6.77%	10.61%	19.88%	4.34%	8.10%	13.04%	5.39%	8.85%	14.41%	8.02%	13.42%	29.98%
<b>Total Sample</b>	0.38%	0.90%	6.90%	0.31%	0.77%	4.66%	0.38%	0.80%	5.99%	0.40%	0.91%	8.33%

## EXHIBIT: SAMPLE COMPANIES

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

## COMPANY PROFILE

**Frederic W. Cook & Co., Inc.** provides management compensation consulting services to business clients. Formed in 1973, our firm has served almost 1,600 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 that 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:

- Compensation Committee Advisor
- Total Compensation Reviews
- Specific Plan Reviews
- Competitive Comparisons
- Directors' Remuneration
- Board/Committee Governance Matters
- Ownership Programs
- Incentive Grant Guidelines
- Performance Measurement
- Change-in-Control Protection
- Strategic Incentives
- Mergers & Acquisitions
- Restructuring Incentives
- Stock Option Enhancements
- Recruitment/Retention Incentives
- All-Employee Incentive Plans

### OUR OFFICE LOCATIONS:

#### *New York*

90 Park Avenue  
35th Floor  
New York, NY 10016  
212-986-6330 phone  
212-986-3836 fax

#### *Chicago*

One North Franklin  
Suite 910  
Chicago, IL 60606  
312-332-0910 phone  
312-332-0647 fax

#### *Los Angeles*

2121 Avenue of the Stars  
Suite 990  
Los Angeles, CA 90067  
310-277-5070 phone  
310-277-5068 fax

#### *London*

(Through Affiliation with  
New Bridge Street  
Consultants)  
20 Little Britain  
London, EC1A 7DH  
020-7282-3030 phone  
020-7282-0011 fax  
www.nbsc.co.uk

*Website address:*  
www.fwcook.com

This report was prepared by Cimi Silverberg with the assistance of many members of our firm. Questions and/or comments should be directed to Ms. Silverberg at [cbsilverberg@fwcook.com](mailto:cbsilverberg@fwcook.com) or (312) 332-0910.