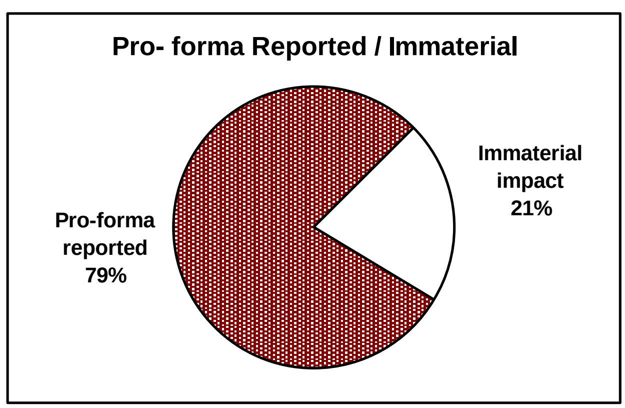
April 17, 1997

1997 Disclosure of FAS 123 Stock Option Valuation

As the first annual reports for 1996 become available, some trends are emerging in companies' responses to the requirement in Financial Accounting Standards Number 123 (FAS 123) that companies disclose the pro forma impact of stock option grants on net income and earnings per share (EPS). As expected, none of the companies that we reviewed chose the apply FAS 123 for expense recognition purposes.

This analysis is based on 100 annual reports gathered to date representing a random sample of publicly traded companies with annual revenues in excess of $1 billion and fiscal years beginning after December 15, 1995. These companies cut across both service and industrial classifications, and the data are shown on a company-by-company basis in the Attachment.

Before exploring trends emerging in option valuation disclosures, it should be mentioned that a surprisingly large number of companies determined that the pro forma impact was immaterial and thus did not report it. As the pie chart shows, 21 percent of this sample deem the pro forma impact to be immaterial. Only three of those choosing this approach also disclosed the fair value of the option, and those ranged between 25 percent and 35 percent of the exercise price. Most did not disclose any of the assumptions they used in determining that the cost was immaterial, although a few referred to the percentage of net income they used as the threshold for immateriality (usually around 3 percent). As discussed below, however, compensation cost is generally recognized ratably over the vesting period, so we may find that some of those who determined the amounts to be immaterial this year



will come to a different conclusion as the full cost is taken into consideration in future years.

Key Statistics

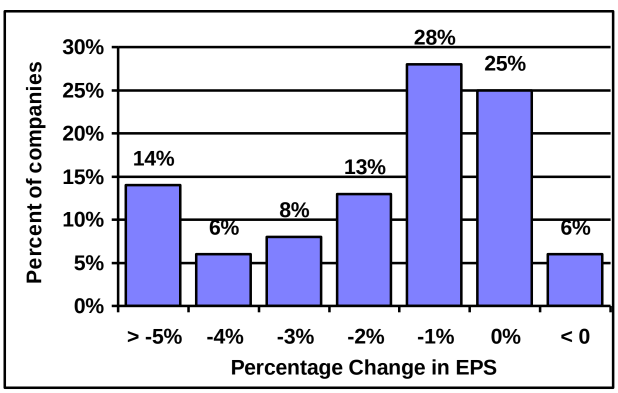
The table below summarizes some of the key statistics for these 100 companies. There are few surprises. It was expected that the option term used for valuation purposes would be well below the ten year maximum term that most companies use for options. It was also anticipated that the median fair value as a percent of grant value would be below the 33 percent that has become a commonly used estimate of a typical Black-Scholes value because, for purposes of financial reporting, companies are looking for the *lowest* supportable option prices.

	# of Companies	25th %ile	Median	75th %ile
Annual Net Revenue ($ millions)	100	3,215	5,939	10,681
Pro forma % change in EPS	79	-3.4%	-1.6%	-0.8%
Fair value as % of grant value	76	20.4%	24.4%	32.3%
Expected option life (years)	78	5.0	5.4	6.9

The differences between the number of companies reporting various valuation statistics result from adopting different approaches to disclosure.

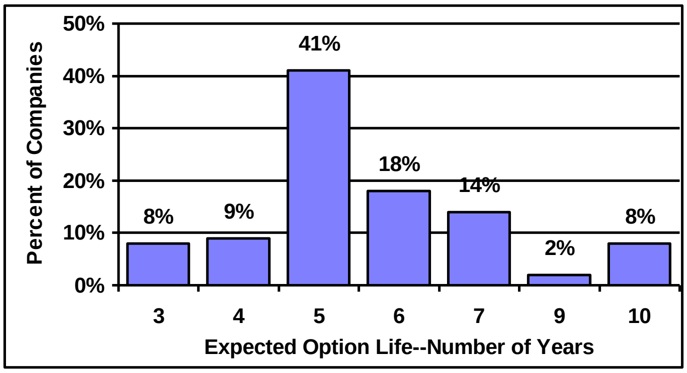
Pro forma Impact on EPS

The percentage change in EPS is to some extent a function of the level of earnings that forms the base of the calculation. However, most companies fell well within a range between no decline and a 3 percent decline. The greatest reduction was 129 percent but this was where a company's reported EPS was only $0.07. Four companies reported an increase in pro forma EPS (the biggest was 7.1 percent). This is possible due to the use of performance grants with "variable-plan" accounting under APB 25. For these companies, the actual cost under APB 25 was greater than the pro forma expense of the present value accounting under FAS 123. Only 11 companies (14 percent) reported EPS reductions greater than 5 percent. As required by the regulations, most companies noted that the pro forma dilution may be less than that it will be in future years, due to the requirement to only include option grants from 1995 forward and the cost being amortized over the vesting period. Thus, we expect the percentage reductions in EPS to be greater in the next round of disclosure.



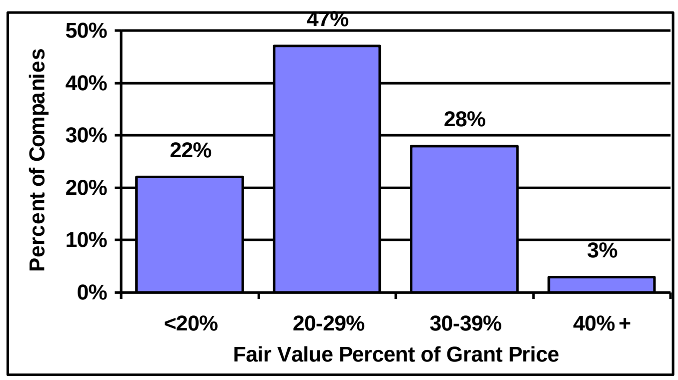
Expected Option Life

As noted earlier, the median option term for purposes of calculating present values was 5.4 years. This chart shows the percentage of companies reporting various expected option lives. Each bar shows the number of companies with a reported option life at the indicated level (5 years includes lives between 5.0 and 5.9 years). Over 50 percent of the companies reported expected option lives between 4 and 7 years. What is most surprising is that over 10 percent of the companies used 9 or 10 years as the expected lives for their option grant. This may have been driven by a lack of data to satisfy an accounting firm's requirements to substantiate an expected life of less than the full option term. Most companies reported option lives as a single number, e.g., 5.4 years. A small number of companies reported a range of years, e.g., 4 to 6 years instead of a weighted average (those companies are not included in the above statistics).



Fair Value as a Percent of Grant Price

As noted earlier, we anticipated that the median fair value would be lower than the 33 percent which has become a common estimate of a normal Black-Scholes value in a mature company. This chart shows the percentage of companies reporting various fair values as a percent of reported weighted average grant price. As above, each bar shows the number of companies with a reported percentage range. Almost 70 percent of the companies reported fair values less than 30 percent of average grant price. Interestingly, several companies disclosed the pro forma earnings impact, along with the assumptions used in the present value calculation, but elected not to disclose the fair value per share of the options granted.



Other Interesting Observations

- Sixteen of the companies in this sample elected not to disclose an option price range table. This table breaks the outstanding options into exercise price “buckets.” The regulations specify the use of this table where the range of exercise prices on outstanding options varies by more than 150 percent.

- Eleven of the companies disclosed the use of reload options (disclosed either in the proxy statement or the annual report). All else being equal, one would expect the EPS impact in these companies to be more significant, because the reload grants would give rise to a pro forma expense along with the regular grants. However, we noticed no consistent difference between the EPS impact or the expected option lives in these companies compared with the others.

- We did not track the existence of broad-based option plans or discount employee stock purchase plans, but clearly to the extent these exist, they are included in the impact on pro forma EPS and should result in a greater reduction.

Conclusion

For companies with fiscal years ending in the middle of the calendar year, these statistics may provide ideas concerning upcoming disclosure, including the reasonableness of assumptions. For companies that have already completed their first round of disclosure, comparison of practices with other companies may assist in confirming or rethinking initial approaches to disclosure for the future.

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