# FASB PROPOSALS ON STOCK OPTION EXPENSING

## HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

COMMITTEE ON ENERGY AND
COMMERCE
HOUSE OF REPRESENTATIVES

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# CONTENTS


Page

Testimony of:

Herz, Robert H., Chairman, Financial Accounting Standards Board ..... 37

Mayer, Steven C., Senior Vice President and Chief Financial Officer, Human Genome Sciences ..... 60

Walker, Hon. David M., Comptroller General, U.S. General Accounting Office ..... 33

White, Rick, President and CEO, Technet, Chairman, International Employee Stock Options Coalition ..... 48

Material submitted for the record:

Barton, Hon. Joe, letter dated August 9, 2004, to William H. Donaldson, Chairman, Securities and Exchange Commission, enclosing followup questions for the record, and responses to same ..... 144

Dingell, Hon. John D., letter dated August 4, 2004, to Robert H. Herz, Chairman, Financial Accounting Standards Board, enclosing followup questions for the record, and responses to same ..... 138

Feldbaum, Carl B., President, Biotechnology Industry Organization, letter dated June 29, 2004, enclosing comments for the record ..... 130

Herz, Robert H., Chairman, Financial Accounting Standards Board, response for the record to questions of Hon. Jim Davis ..... 134

Mayer, Steven C., Executive Vice President and Chief Financial Officer, Human Genome Sciences, Inc., letter dated June 29, 2004, enclosing comments for the record ..... 120

Trumka, Richard L., Secretary-Treasurer, AFL-CIO, prepared statement of ..... 116

# FASB PROPOSALS ON STOCK OPTION EXPENSING

**THURSDAY, JULY 8, 2004**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 1:35 p.m., in room 2123, Rayburn House Office Building, Hon Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Shadegg, Bass, Terry, Ferguson, Issa, Barton (ex officio), Schakowsky, Towns, Brown, Stupak, Green, Strickland, Davis, and Dingell (ex officio).

Staff present: David Cavicke, majority counsel; Chris Leahy, majority counsel and policy coordinator; Brian McCullough, professional staff, Will Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. Good afternoon. Today the subcommittee will convene and will consider what all of us believe are important questions concerning accounting treatment of stock options.

This hearing continues the bipartisan work we have done in this subcommittee to improve accounting standards. This work has included examination of restatements at Enron, Andersen, and Freddie Mac. It has also involved extensive oversight on modernization of FASB and the process by which FASB makes its rules.

I am pleased that FASB has acted on a number of our recommendations, including closing loopholes on special purpose entities and speeding up the process of decisionmaking.

I want to also thank Ranking Member Jan Schakowsky, for her spirit of bipartisanship that has helped this subcommittee. I also would like to thank Chairman Barton for his leadership and for facilitating this hearing, and Ranking Member John Dingell for his long leadership and vision on accounting issues.

My colleagues, currently FASB provides that companies may either expense options provided to employees or disclose the expenses in footnotes. Now, companies that disclose the expense in footnotes do not reflect the expense in their reported earnings. About 575 companies, mostly since the excesses of the 1990's, have decided voluntarily to expense options. Now, these companies include General Motors, Ford, Citigroup, Coca-Cola and Microsoft. The rest of

public companies that have options choose not to reflect their expense as reported earnings.

FASB is considering a rule change that would require companies to expense stock options, thereby informing investors of the effect of the options grants on earnings. This proposal would make GAAP consistent with international accounting standards which in January will require the expensing of options. This proposal by FASB is controversial, we grant that, and members have legitimate views on both sides of this issue.

The rule would cause stock options to be treated like other types of compensation paid to employees, including cash and stock, which expense is reflected in companies' quarterly earnings. FASB's proposal would also make GAAP consistent with the tax treatment of options. Currently, companies don't have to report the expense of options to their shareholders but can deduct the cost of the same options on their taxes. I understand that Alan Greenspan, Paul Volcker, SEC Chairman Bill Donaldson, Treasury Secretary John Snow, and of course Warren Buffett support FASB's position.

Many of our leading technology companies who are represented here today oppose FASB's position. They argue that options are difficult to value and often expire worthless. As such, the options should not count as an expense.

We learned from Baruch Lev in a previous hearing that all numbers in accounting, be they accounting, account receivables, pension expense, or depreciation and amortization, are literally just estimates.

There are rigorous means available for establishing the values of options. These means are used to tell senior executives the expected value of their pay package. Companies also seem to have an easier time determining the value of options when they deduct them on their corporate taxes.

My good colleague, Congressman Richard Baker, has introduced legislation, H.R. 3574, which would direct the SEC to prevent FASB from requiring the expensing of options. The Financial Services Committee has approved this legislation, although the bill has not yet—the committee has not yet filed the report. I expect our witnesses will discuss this bill today. I hope they will.

There are two points that I would like to highlight for members of this subcommittee on this legislation. I am concerned that the legislation may effectively forbid the more than 575 companies that are voluntarily expensing options from doing so in the future. I want each of our witnesses to explain to us if this reading of this legislation is correct by me: If companies that are voluntarily expensing options can no longer do so upon inaction of this legislation, some of those 575 companies, wouldn't they be in violation of GAAP? This violation could lead to a significant number of restatements of earnings for those companies.

Regardless of your position, my colleagues, on the merits of this legislation, forced restatements are not a desirable outcome. During questions, I will ask each witness to address the question of how the legislation affects those companies that are voluntarily expensing their options.

And second, my colleagues, the legislation provides that options granted to the top five executives in a company should be ex-

pensed. However, the legislation requires by statute that the volatility of these options be assumed to be zero. The central insight—the central insight of Fisher Black and Myron Scholes for which they won the Nobel Prize was that the value of options is determined predominantly by their volatility. If volatility is required by statute to be zero, then the value of the options will likely be zero as well. Stock prices go up, they go down. That is volatility. I would like the witnesses to address the question of why assumed volatility of zero for options should be mandated by statute by this Congress.

If this legislation moves to the floor, I would encourage Members on both sides of this issue to support amendments that I believe would cure those two defects.

On the proposal by FASB, I recognize that expensing options involves estimating their value. Sometimes those estimates will be incorrect. Accounting statements are supposed to provide investors with the best current view of the assets and liabilities of a company at a particular time. Opponents of FASB are wanting to keep treating options as though they are worthless in all situations. If they are worthless, people wouldn't want them. So I prefer that we have financial statements that be approximately correct rather than completely wrong.

So I look forward to the testimony. With that, the distinguished colleague, Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you, Chairman Stearns, and I, too, appreciate your bipartisan approach to this committee's work and for holding today's hearing on one of the most important issues under our subcommittee's jurisdiction, accounting standards.

Ranking Member Dingell, your presence here signifies how important accounting standards are to corporate responsibility, investors, and pension holders, and our country's economic well-being, especially since you took time out on your birthday to be here. So I want to wish you a very, very happy birthday.

I also would like to welcome Congressman Rick White. I thank you for joining us to discuss FASB and the proposed rules that would require companies to expense all stock options issued to their employees.

We know from the corporate scandals of the past few years that accurate and transparent accounting is vital to corporate accountability and shareholder confidence. Yet, the accounting treatment of stock options allows corporations to continue to distort their true financial standing. Stock options make up 80 percent of compensation packages for corporate managers. In 2003, CEO pay at 350 major U.S. public companies averaged $8 million, with stock options typically providing the largest compensation component. Despite those facts, stock options are the only form of compensation that may be completely absent from corporate financial statements.

The unique and unwarranted accounting treatment afforded stock option has fueled abuses linked to excessive executive pay, inflated company earnings, dishonest accounting, and corporate misconduct. Nobel Prize winner Joseph Stiglitz believes that the absence of stock option expensing requirements has, quote, played an important part in the spread of other financial chicanery, end quote, where corporate energy and creativity was, quote, directed

less and less into new products and services and more and more into new ways of maximizing executives' gains at unwary investors' expense. Unquote.

A September 2002 report by a blue ribbon panel of the Conference Board found that the current accounting treatment of stock options helped foster a vicious cycle of increasing short-term pressures to manipulate earnings, to bolster stock price, so that those receiving options could cash in, take the money, and run.

FASB's proposed rule would remove these perverse incentives, and help bring transparency to corporate financial statements. Investors and pension plan managers want the kind of accurate financial information that FASB's rule would provide. It would help them make informed investment decisions about retirement security.

Since 2002, at least 576 corporations have decided that expensing options is a sound accounting practice that attracts investors and have voluntarily begun expensing the options that they grant all their employees. Yet, some of our colleagues are trying to prevent FASB's proposed rule with H.R. 3574, the so-called Stock Option Accounting Reform Act. If this bill is enacted, it would not only stop FASB's rule but would in fact stop those nearly 600 corporations from voluntarily providing an accurate accounting of their expenses.

While it claims to be a compromise and would require the expensing of options given to the top executive along with the four highest paid officers, it does so in a way that Warren Buffett describes as, quote, mathematical lunacy, unquote. In fact, H.R. 3574 is written so that the options would have no value and would be reported as a no cost expense. This is not a compromise but a giveaway to corporations at the expense of investors.

In the wake of Enron, Tyco, WorldCom, and other corporate scandals, this is the wrong message to be sending to all those workers and investors who lost their life savings and retirement security, and it is the wrong policy to pursue if we want to boost consumer confidence and improve our economy.

Far too often Congress has weighed in at the behest of powerful special interests to back reforms like the expensing of stock options. It is my hope that we have learned from the past and will let FASB do its job.

I look forward to hearing the testimony of our witnesses, and I thank you, Mr. Chairman.

Mr. STEARNS. I thank the gentlelady.

The full chairman of the Energy and Commerce Committee, Mr. Barton.

Chairman BARTON. Thank you, Mr. Chairman. I, too, want to extend my best wishes to John Dingell on his birthday today. We had a little birthday party for him upstairs with the staff, and we appreciate him being in good cheer today and being here.

I also want to welcome Rick, who used to be a member of this committee, and encourage Sherrod Brown and Bart Stupak to eat lots of ice cream and cake so they won't be in good shape for tonight's congressional baseball game which we are going to have out at the field at 7 o'clock.

Thank you, Mr. Chairman, for holding this hearing. It is a proper and appropriate exercise of the Energy and Commerce Committee's jurisdiction. It is obvious that the Financial Accounting Standards Board proposed rules for stock option expensing is an issue that is clearly within the jurisdiction of the Energy and Commerce Committee and within the meaning of the memorandum of understanding that was reached between this committee and the Financial Services Committee in January 2001. That MOU was a document that was negotiated by the Speaker's office, former Chairman Tauzin, and Chairman Oxley to define the jurisdiction over the setting of accounting standards by the Financial Accounting Standards Board. And I quote: This hearing follows 3½ years of subsequent work in this area, including the historic hearings that this committee held on the collapse of Enron, the problems at WorldCom, and the general corporate scandals that we have had in the last 3 or 4 years. Those hearings were led by Chairman Tauzin and led on the minority side by Congressman Dingell. The Energy and Commerce Committee is a committee that will get to the bottom of things, and we will exercise our jurisdiction in an area that we clearly have jurisdiction.

Having said that, I think I need to comment on the record on some issues that are probably on a lot of people's minds. The Financial Services Committee ordered H.R. 3574, the Stock Option Accounting Reform Act, out of their committee several weeks ago. I did not oppose that. I didn't oppose obviously Mr. Baker, Congressman Baker, and Congressman Oxley and others reporting that bill. I did ask the Energy and Commerce majority staff to ensure that our committee's jurisdiction be protected. Quite frankly, that is what committee chairmen are supposed to do, and that is certainly something that Chairman Dingell did when he was chairman of this full committee.

When the House leadership announced last week that H.R. 3574 would be on the floor this week, you know, I made a decision that we would cooperate—and I want to underline cooperate—with that bill going to the floor. I felt and continue to feel that the Energy and Commerce Committee should be entitled to a referral of the bill, and instructed our general counsel to go to the Parliamentarian and ask that it be referred. We also at the staff level touched base with the Rules Committee. The Parliamentarian did issue a ruling that had the Financial Services Committee reported their bill, had they actually filed their report, the Parliamentarian indicated that it would be referred to our committee.

But I did tell the leadership that if we did get a referral, we would hold a hearing today, a legislative hearing today on the bill and would report the bill today so that it would be on the floor tomorrow. At no time did I indicate to the Speaker's office, the majority leader's office, the Rules Committee that this committee would in any way obstruct H.R. 3574 from being reported to the floor for an up or down vote by the House of Representatives. It was not my decision to not file the report by the Financial Services Committee. That is a decision that was made by that committee.

So having said that, what we are doing today, since there is no bill, there is no committee report that has been filed by the Financial Services, today's hearing is not a legislative hearing, it is sim-

ply an information hearing, and I am very pleased that FASB and various private sector individuals are here so that we can have this hearing and get additional information on the record.

There are substantial policy issues involved. Those issues need to be aired. The witnesses before us have a wealth of expertise and are very knowledgeable on the matters that are important in how we set these standards, if we set standards, on how stock options are to be expensed. We have asked the witnesses to share their views because they plainly have something to say, and I believe they deserve to be heard by this committee.

The decision has been made on the bill that was reported out of Financial Services, 3574, to not file the report and not report it to the floor tomorrow. That is not the fault of this committee or of my responsibilities as chairman of the Energy and Commerce Committee. I respect that decision if that is the decision that has been made, but in some ways I regret it because I too am concerned about the pending FASB proposal, and I want the head of FASB to understand that.

I personally think that it is very difficult to value a stock option at the time it is granted. No one can predict with any degree of certainty where the future is going to take the valuation of these companies. Sometimes the stock price will go up and the option will become extremely valuable. Other times, certainly in the last 3 or 4 years, stock prices stagnate or decline precipitously and the options are worthless. I don't think that we should mandate at the Federal level the expensing of options that turn out to be worthless. You know, I think you would set a value on something that can actually be put in the bank. If you give me a cash bonus of $1,000, it is worth $1,000. You know, there are ways to determine real value, but some sort of a guess about where the stock price might be at a date certain in the future is almost by definition going to be proven wrong.

Financial analysts analyze companies for a living. They are very aware of the stock option grants that various companies give, the impact that they have or might have on earnings, and presumably these analysts have already discounted into the price of that company's stock whatever the dilution value is, if any, of those options. The question becomes that requiring mandatory expensing, will that in itself change the valuation of a company? If it does not affect the valuation of the company, what is gained?

What is certain is that a change to the accounting standards that would require expensing would transform corporate governance and would change methods of compensation and possibly impact our international economic competitiveness. That is a very, very serious issue that needs to be seriously addressed. I hope that we can address some of those issues at the hearing today. I hope we can resolve these issues.

If in fact it is a decision that needs to be made that we need to report a Federal initiative, a Federal bill on these issues, to the extent this committee has jurisdiction we will work to report a responsible bipartisan bill.

I thank Chairman Stearns for holding the hearing. I look forward to listening to the witnesses, and I thank their attendance at today's hearing. With that, I yield back the balance of my time.

Mr. STEARNS. And I thank the chairman for his leadership.

The gentleman from Michigan whose birthday is today that we all wish him the best wishes, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I thank you, and I commend you for holding this very important hearing.

I want to say a word about my friend, Mr. Barton, the chairman of the full committee. First, thanks for his good wishes on my birthday. A day on the green side of the sun is quite an event in my life. I want to thank him for his kind comments.

I also want to commend him for the courageous and energetic way in which he has dealt with this committee's jurisdiction and the right of this committee to address matters within the longstanding jurisdiction of this committee over accounting, accounting standards, and the Financial Accounting Standards Board, FASB. I want to point out that I know that this is not always an easy task, and I want him to know that I am appreciative, as other members of this committee, of the rare and courageous way in which he has addressed this matter, and I want him to know of my appreciation. I thank you.

I also want to address the exposure draft of FASB and the Baker bill. These two items, considered along with or against each other, are very significant issues that deserve the attention of this committee and the public. This committee has been interested in the question of bad and dishonest accounting going back into the 1970's when we first addressed the question of dishonest accounting in connection with the Penn Central bankruptcy. In that instance, the committee found that there was out and out lying in the accounting, that the insiders inside the corporation got out of the stock, left it to the investors, walked away with hundreds of millions of dollars, and left the taxpayers with a bill for restructuring railroads in the northeast United States that cost the taxpayers over $7 billion.

It is interesting to note that neither the ICC nor the Internal Revenue nor the shareholders nor the SEC nor the then ICC had the vaguest idea of what was happening, because the accountants had lied, and we were called upon to pony up huge sums of money on behalf of the taxpayers to address this problem.

Since that time, you can look at the records of corporate failures, and you will find consistently that those records of corporate failures are almost invariably bottomed on or have as a major participating element dishonest, incompetent, and improper accounting. Tyco, AOL, WorldCom, Sunbeam, and of course Enron are splendid examples of how this can be done.

Interestingly enough, the Europeans are beginning to move toward more responsible kinds of accounting in that they seek in their handling of these matters to see to it that the accountant tells everybody truthfully what the state of the corporation is so that investors know, so that the corporate officers know, and so that the public knows the state of affairs in that corporation.

It is to be observed here that the Congress seeks to take from FASB the authority to address the problem of responsible accounting standards.

I don't know exactly what is going to be the result of this by the FASB, and I am willing to wait. I would note that the investigative

hearings chaired by our colleague Mr. Greenwood as to the causes and effects of Enron, WorldCom, HealthSouth, and other accounting debacles, and the hearings chaired by you, Mr. Chairman Stearns, into the failings of U.S. accounting standards are so that faulty behavior in accounting has facilitated these debacles, and we are finding that there have been, amongst other things else, stock option abuses revealed, accounting standards riddled with loopholes, audit failures, massive failures of corporate governance, amongst other things.

We have directed FASB to fix the problems within its purview, such as special purpose entities, stock option accounting, and establishing a framework for measuring financial and nonfinancial assets and unfair value. It is, after all, what accounting is about. And if you look at the accounting of other countries, you will find that other countries have seen their economies go south because the accounting in those countries is so bad. And, indeed, it is so bad that not only do the investors, the government not know the state of affairs of the accounting or the state of affairs of those corporations, but the owners and the operators and the high corporate officers of those corporations have handled those matters so poorly and they have been so diligent in lying to themselves and everybody else that nobody has the vaguest idea what in the name of common sense the situation might be.

So fixing a situation of this sort so that finally the corporations are able to restructure themselves and come to a sound accounting and to a sound business state is almost impossible.

We are here today because FASB issued an exposure draft requesting public comment on a proposal to require that companies account for stock options as an expense using the fair value method. More than 575 American companies have announced their intention to or have begun to voluntary expense their options at fair value. These corporations can do it. Why is it that others cannot?

I would note that the comment period for FASB's proposal expired at the end of June. FASB is now in a months long stage of reviewing all comment letters, including public hearings, and redeliberating and revising the proposed standard. This is a fair and an open process, one with which I agree and with which I think no one may take criticism. I cannot say today whether I support or disagree with the FASB standard since it is still in a state of flux. I do agree with the general principle, and I observe that it is required under international accounting standards by foreign competitors of the United States.

As for the Baker bill, all I can say is: "What were they thinking?" I thought this country had seen enough phony accounting, and yet here we have before us a piece of legislation which sanctifies and indeed which endorses phony, false accounting. It also prohibits honest accounting by corporations that feel that this is in their best interest and in the interests of the shareholders. This is a clear case study in why Congress should not be in the business of writing accounting standards. It decrees that the company shall count options as an expense for the five highest corporate executives but not for anybody else. A most curious decision. The bill prohibits voluntary expensing of options by the 575 companies that are currently and voluntarily expensing their options. It mandates that

when a company is calculating the expense of options for the top five executives, it shall assume that the price volatility is zero.

Has anybody looked at the different indexes in the securities markets? They will tell you clearly that volatility is never zero in the stock market. And they are saying then that it never moves up and it never moves down. If there ever was an Alice in Wonderland, make believe world, we are seeing it here.

There are other gems of wisdom before us. I ask unanimous consent to insert in the record FASB's letter analyzing the bill in response to questions that I have posed.

Mr. STEARNS. By unanimous consent, so ordered.

[The information referred to follows:]

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ROBERT H. HERZ
Chairman

VIA EMAIL

June 22, 2004

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515-6115

Dear Representative Dingell:

Thank you for your letter of June 18, 2004, that raises a number of questions concerning H.R. 3574, the "Stock Option Accounting Reform Act" ("HR 3574").

The Financial Accounting Standards Board ("FASB" or "Board") is an independent private-sector organization. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, comparable, and unbiased information to make decisions.

HR 3574 appears to address issues relating to the Board's current project to improve the accounting for equity-based compensation. In connection with that project, in March of this year, the Board issued for public comment an Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"). Following the end of the Proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the Proposal. Only after carefully evaluating the input at public meetings and potential improvements to the Proposal will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year. The attachment to this letter includes a brief summary of the project.

Consistent with the FASB's mission, our technical expertise is limited to financial accounting and reporting matters. We, therefore, do not have expertise relating to the US federal securities laws or statutory or legislative interpretation generally. Thus, the responses to your questions that follow are subject to that limitation.

**1. What is the practical effect of this bill on accounting for stock options by (i) the top five executives at SEC-registered companies, (ii) other option recipients at SEC-registered companies, and (iii) option recipients at private companies?**

As explained below, the practical effect of HR 3574 on the accounting for stock options would appear to be that SEC-registered companies would be required to significantly understate the total amount of compensation cost relating to stock options in their financial reports. HR 3574, therefore, would appear to result in a distortion of those companies' reported earnings, profitability, and other key financial metrics.

HR 3574 would appear to prohibit the Securities and Exchange Commission ("SEC") from recognizing any final standard (or any existing standard relating to the expensing of stock options) unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.[1]

HR 3574 also would appear to require that only stock options granted after December 31, 2004, to the chief executive officer and the four other most highly compensated employees of certain SEC-registered companies be reported as a compensation expense in those companies' financial reports.[2] Thus, if an SEC-registered company grants stock options to employees other than the top five executives, that compensation cost would not be reported in the company's income statement. There, however, is no accounting or economic theory that would support such a result. As the Congressional Budget Office recently concluded in its analysis of the accounting for stock options, "If firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' reported net income will be overstated."[3]

HR 3574 also would appear to require that for purposes of determining the fair value of the stock options granted to the top five executives the assumed volatility of the underlying stock shall be zero.[4] It is generally accepted that a large part of a stock option's fair value is the result of volatility of the underlying stock price.[5] Thus, if an SEC-registered company grants stock options to the top five executives, the amount of

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[1] HR 3574, the "Stock Option Accounting Reform Act," 108th Congress, 2d Session (as reported by the Committee on Financial Services), Section 3(a)(3).
[2] HR 3574, Section 2(m).
[3] Congressional Budget Office, "Accounting for Employee Stock Options," (April 2004), Section 2 of 3, page 1 of 2.
[4] HR 3574, Section 2(m)(3)(B).
[5] Testimony of Robert C. Merton, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, "Hearing on H.R. 3574, the Stock Option Accounting Reform Act" (March 3, 2004), page 2 of 2. In general, the higher the volatility of the underlying stock, the higher the option's value will be—because of the greater chance that the market price of the stock will rise above the strike price of the option before the term of the option expires.

that compensation cost reported in the company's income statement would be significantly understated.

A recent *Washington Post* editorial commented on the "top five executives" provisions of HR 3574, stating:

> The second problem with the bill is its illogical content. In the past, opponents of expensing options have claimed that the value of options is unknowable. But the House bill abandons that claim by requiring that companies include in their profit-and-loss statements the value of options for their top five executives. Having conceded that, however, the bill goes on to say that the cost of options granted to employees outside the top circle should be left out, implying that they cost nothing. But they do not cost nothing. In high-tech companies, which grant options generously to middle-ranking employees, the top five executives get only a small fraction of the total – less than 5 percent in the case of Intel Corp. or Cisco Systems Inc.
>
> Moreover, the House bill stipulates that companies should use an unorthodox method for valuing options that minimizes their worth. If the bill became law, the options granted by Intel last year would force it to deduct a modest $3.5 million from its reported profit – compared with the hefty $991 million it would have to deduct under the proposed FASB reform. Cisco, for its part, could report $1.1 billion more in profit if the House bill passed. Small wonder that Intel and Cisco have led the lobbying charge in favor of the legislation.[6]

HR 3574 also would appear to exempt certain SEC-registered companies that are "small business issuers" from having to report any compensation expense for stock options granted.[7] Similarly, HR 3574 would appear to exempt certain SEC-registered companies from having to report any compensation expense for stock options granted to employees for three years after an "initial public offering."[8] In both cases, to the extent that a qualifying SEC-registered company grants stock options to its employees, the amount of compensation cost would be understated in the company's income statement.

Finally, HR 3574 would not appear to address the accounting for stock options by private companies. Thus, those companies would continue to account for stock options under

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[6] "High-Tech Holdup," *The Washington Post* (June 10, 2004), page A18.
[7] HR 3574, Section 2(m)(4)(A).
[8] HR 3574, Section 2(m)(4)(B).

existing accounting standards. Those standards (and the standards for SEC-registered companies) are proposed to be changed as a result of the FASB's current project to improve the accounting for equity-based compensation.

2. **Ford Motor Company, General Motors, Citigroup, Microsoft Corporation, and more than 500 other companies, large and small, have voluntarily begun expensing stock options under the fair value method, and I commend them for doing so. Is it true, as I have been advised by counsel, that this bill, especially when read against Rule 4-01(a)(1) of Regulation S-X, would make it illegal for companies to continue to voluntarily expense stock options?**

As explained below, HR 3574 would appear to prohibit SEC-registered companies from continuing to voluntarily expense stock options.

Rule 4-01(a)(1) of Regulation S-X states:

> Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.

As indicated above in response to Question 1, HR 3574 would appear to prohibit the SEC from recognizing any accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.

Existing accounting standards prescribe as the preferable method of accounting for employee stock options a grant date fair value measurement approach.[9] Those more than 575 companies that have begun voluntarily expensing all employee stock options are required to follow the preferable method.[10] That method does not encompass an exercise or other settlement date measurement approach as would appear to be required by HR 3574. Thus, the existing voluntary expensing of all employee stock options would appear to be prohibited.

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[9] Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 11.

[10] *Id.*; Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Accounting Issues: 576 Companies Have Voluntarily Adopted Option Expensing Under the Fair Value Method," Bear Stearns (April 29, 2004).

**3. The bill provides that "the assumed volatility of the underlying stock shall be zero" under whatever pricing model is used. Is it true that this would allow companies to ignore reality and show near zero value for their option plans? Absent this provision, what economic considerations would determine the assumed volatility of the underlying stock?**

As explained below, the zero volatility assumption contained in HR 3574 would appear to require that SEC-registered companies significantly understate the stock option compensation costs for their top five executives. In some cases, the amount of the understatement would be 100 percent because the compensation cost would be zero. The Proposal provides guidance for determining the expected volatility of the underlying stock when determining the fair value of employee stock options.

As indicated above, in response to Question 1, HR 3574 would appear to require that for purposes of determining the fair value of the stock options granted to the top five executives the assumed volatility of the underlying stock shall be zero (often referred to as the "minimum value approach"). It is generally accepted that a large part of a stock option's fair value is the result of volatility of the underlying stock price. Thus, if an SEC-registered company grants stock options to the top five executives, the amount of that compensation cost reported in the company's income statement under the minimum value approach would be significantly understated.

The minimum value approach of HR 3574 would also appear to permit companies to structure their employee stock option grants to ensure stock option compensation costs of zero. As demonstrated by University of California-Berkeley, Haas School of Business, Professor Mark Rubinstein in the *Journal of Derivatives*, the minimum value approach can be easily manipulated to drive the reported value to zero or near zero.[11] This can be done by raising the exercise price and multiplying the number of options in order to maintain the real value of the grant while lowering its reported minimum value.[12]

The Proposal provides implementation guidance that illustrates the fair-value-based method of accounting for stock-based compensation arrangements with employees and elaborates on certain other aspects of the Proposal.[13] That guidance includes the following economic considerations and other factors to consider in estimating the expected volatility of the underlying stock for purposes of determining the fair value of an employee stock option:

a. The term structure of the volatility of the share price over the most recent period that is generally commensurate with (1) the contractual term of the option if a lattice

[11] Mark Rubinstein, "On the Accounting Valuation of Employee Stock Options," *Journal of Derivatives*, fall 1995, page 21.
[12] *Id.*
[13] Proposal, paragraph B1.

model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used.

b. The implied volatility of the share price determined from the market prices of traded options. Additionally, the term structure of the implied volatility of the share price over the most recent period that is generally commensurate with (1) the contractual term of the option if a lattice model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used.

c. For public companies, the length of time an entity's shares have been publicly traded. If that period is shorter than the expected term of the option, the term structure of volatility for the longest period for which trading activity is available should be more relevant. A newly public entity also might consider the volatility of similar entities. A nonpublic entity that elects the fair-value-based method might base its expected volatility on the volatilities of entities that are similar except for having publicly traded securities.

d. The mean-reverting tendency of volatilities. For example, in computing historical volatility, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid or a major restructuring. Statistical models have been developed that take into account the mean-reverting tendency of volatilities.

e. Appropriate and regular intervals for price observations. If an entity considers historical volatility or implied volatility in estimating expected volatility, it should use the intervals that are appropriate based on the facts and circumstances and provide the basis for a reasonable fair value estimate. For example, a publicly traded entity might use daily price observations, while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.

f. Corporate structure. An entity's corporate structure may affect expected volatility. For instance, an entity with two distinctly different lines of business of approximately equal size may dispose of the one that was significantly less volatile and generated more cash than the other. In

> that situation, an entity would consider the effect of that disposition in its estimate of expected volatility.[14]

The Proposal's Notice for Recipients includes six issues seeking additional input on the measurement issues raised by the Proposal, including whether "the Board should require a specific method of estimating expected volatility."[15] The input received on those issues and all other issues will be carefully considered by the Board, consistent with the FASB's Rules of Procedure, at public meetings prior to the issuance of any final standard.

**4. How do international accounting standards deal with accounting for stock options?**

As explained below, international accounting standards deal with the accounting for stock options in a manner that is substantially similar to the approach contained in the Proposal.

In February 2004, the International Accounting Standards Board issued International Financial Reporting Standard 2, *Share-based Payment* ("IFRS 2"). IFRS 2, effective in 2005, requires the expensing of all employee stock options based on a grant date fair value measurement approach that is similar in most respects to the approach contained in the Proposal.[16] It is expected that companies in over 90 countries around the world will begin applying IFRS 2 beginning January of next year.

Similarly, in September 2003, the Canadian Accounting Standards Board issued *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870 ("Section 3870"). Section 3870, effective in 2004, also requires the expensing of all equity-based compensation based on a grant date fair value measurement approach that is similar in most respects to the Proposal and IFRS 2.[17]

Of note, over 350 of the Canadian enterprises that implemented Section 3870, and hundreds of other foreign companies that will be soon implementing IFRS 2, are registrants under the US federal securities laws and, therefore, subject to the rules and regulations of the SEC.

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[14] Proposal, paragraph B25 (footnote references omitted).
[15] *Id.*, pages *ii* and *iii*.
[16] *Id.*, paragraph C48.
[17] Letter from Paul Cherry, FCA, Chair, Accounting Standards Board to The Honourable Michael G. Oxley, United States House of Representatives (May 7, 2004), page 1.

5. **The Energy and Commerce conferees were appointed by the Speaker to the House-Senate conference committee for consideration of Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 (SOX) which dealt with, among other things, the standards for Securities and Exchange Commission (SEC) recognition of "accounting standards established by a standard setting body" and the annual accounting support fee for that standard setting body, in order to strengthen the independence of FASB and the integrity of its standard setting process. I understand that these provisions have been implemented. What effect would this bill have on these sections of SOX and the rules implemented thereunder?**

As explained below, HR 3574 would appear to have results that are inconsistent with the language and intent of Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 ("SOX") and the related SEC actions implementing those provisions.

The legislative history of SOX is clear that Sections 108 and 109 were intended to enhance the independence of the FASB to assist it in achieving its mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises.[18] In implementing Sections 108 and 109 of SOX, the SEC, in April 2003, issued a Policy Statement.[19] The Policy Statement, consistent with the language and intent of SOX, reemphasizes the importance of the FASB's independence:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[20]

Section 108 of SOX also indicates that Congress intended that the Board act more promptly in making changes to accounting principles.[21] The Policy Statement, consistent with that view, stated that the Commission expects the FASB to "improve the timeliness with which it completes its projects."[22]

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[18] Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.
[19] "Policy Statement: Reaffirming the Status of the FASB as Designated Private-Sector Standard Setter," Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).
[20] Policy Statement, page 5 of 8.
[21] Sarbanes-Oxley Act of 2002, Section 108(b)(1)(A)(iv).
[22] Policy Statement, page 4 of 8.

Finally, Section 108 of SOX indicates that Congress supported the FASB's ongoing efforts to promote "international convergence on high quality accounting standards."[23] The Policy Statement contains nearly identical language.[24]

As indicated above in response to Question 1, HR 3574 would appear to prohibit the SEC from recognizing any FASB standard unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted. The former condition suggests that the quality of financial accounting and reporting for stock options should be subjugated to the protection of certain specified public policy goals. The latter condition prescribes a measurement approach that is generally inconsistent with the measurement approach contained in (1) existing US accounting standards, (2) IFRS 2 and Section 3870, and (3) the Proposal. Mandating either condition through legislation appears inconsistent with the language and intent of SOX and the Policy Statement.

Many preparers, auditors, and users of financial reports (including Members of the Congress and federal regulators) agree that HR 3574 is inconsistent with the language and intent of SOX and the Policy Statement because it would appear to weaken the independence of the FASB, harm the integrity of the standard-setting process, and have an adverse impact on achieving international convergence of high-quality accounting standards.[25] In recent testimony before Congress, The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, stated:

> I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:
>
> "Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?"
>
> "Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet

[23] Sarbanes-Oxley Act of 2002, Section 108(b)(1)(A)(v).
[24] Policy Statement, page 4 of 8.
[25] Testimony of Robert H. Herz, Chairman, and George J. Batavick, Board Member, Financial Accounting Standards Board, before the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services, hearing on "The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs" (May 4, 2004), Attachment 5.

> the need, in a world of globalized finance, for a common set of international accounting standards?"[26]

**6. What practical effect would this bill have on the issue of the setting of accounting standards by FASB with respect to accounting for stock options? In answering this question, do you believe that Section 5 of the bill has any practical effect?**

As explained below, the practical effect of HR 3574 would appear to be to delay the implementation of, and thereafter severely constrain the content of, any FASB accounting standard relating to expensing stock options. Section 5 of HR 3574 does not appear to obviate that result.

Section 5 of HR 3574 states that "[n]othing in this Act shall be construed to limit the authority over the setting of accounting principles by any accounting standard setting body whose principles are recognized by the Securities and Exchange Commission." As indicated above in response to Question 5, the Policy Statement issued to implement Section 108 of SOX reaffirmed that the SEC would continue to recognize as "generally accepted" the accounting standards established by the FASB.[27]

Notwithstanding the provisions of Section 5 of HR 3574 and the Policy Statement, as indicated above in response to Question 1, Section 3 of HR 3574 would appear to prohibit the SEC from recognizing any FASB accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted. The latter condition prescribes a measurement approach that is generally inconsistent with the measurement approach contained in (1) existing US accounting standards, (2) IFRS 2 and Section 3870, and (3) the Proposal.

Commenting on the practical effect of HR 3574, Robert Denham, Chairman and President of the Financial Accounting Foundation, the nonprofit corporation that appoints members of the FASB and oversees its process, stated:

> H.R. 3574 preempts and overrides the FASB's ongoing effort to improve accounting for equity-based compensation through public due process. . . . Once Congress starts setting accounting standards through its

[26] Testimony of The Honorable Paul A. Volcker, before the Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs, United States Senate, "Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board" (April 20, 2004), page 2 of 2.
[27] Policy Statement, page 5 of 8.

> political process, the integrity of accounting standard setting in this country will be dangerously compromised.
>
> If enacted, H.R. 3574 would also severely impede the important ongoing efforts by the FAF and FASB to achieve international convergence of high-quality accounting standards. . . . Because the International Accounting Standards Board has recently issued a final standard requiring the recognition of compensation cost for the fair value of employee stock options, Congressional action would result in a major difference between US and international standards, thus undermining the movement toward international convergence previously encouraged by Congress in the Sarbanes-Oxley Act, by the Securities and Exchange Commission, and by many investors and other market participants.[28]

* * * *

Thank you again for your letter and your long-time and continuing support of the independence of the FASB. If you have any further questions or comments, please feel free to contact me directly or our Washington, DC representative, Jeff Mahoney (703-243-9085).

Yours Truly,

Robert H. Herz

Attachment

[28] Financial Accounting Foundation News Release, "Financial Accounting Foundation Chairman Responds to House Subcommittee's Action on 'The Stock Option Accounting Reform Act'"(May 17, 2004).

**ATTACHMENT**

## A BRIEF SUMMARY OF THE FINANCIAL ACCOUNTING STANDARDS BOARD'S PROJECT TO IMPROVE THE ACCOUNTING FOR EQUITY-BASED COMPENSATION

Under existing United States ("US") generally accepted accounting principles ("GAAP"), only stock options granted to employees that meet certain specified criteria (so-called fixed plan employee stock options) are not required to be reported as a compensation expense in the income statements of those companies that grant them. All other forms of employee compensation, including cash salaries, bonuses, fringe benefits, restricted stock, stock warrants, performance-based stock options, indexed-based stock options, and employee stock ownership plans, are, and have long been, required to be reported as an expense. Similarly, when stock-based grants of any form are issued to *nonemployees* for goods or services, they also are, and have long been, required to be reported as an expense. The exception for fixed plan employee stock options is clearly an anomaly in today's financial accounting and reporting model in the US.

In March 2003, at a public meeting, the Board decided by unanimous vote to add a project to its agenda to address issues relating to improving the accounting for equity-based compensation. The project was in response to the high level of public concern expressed by many individual and institutional investors, financial analysts, the major accounting firms, study groups such as the Conference Board Commission on Public Trust and Private Enterprise, and many other parties, including a number of Members of Congress, about the need to improve the accounting for equity-based compensation. More specifically, many expressed support for eliminating the fixed plan employee stock option anomaly.

Many believe that the anomaly results in significant distortions in reporting of earnings, operating results, and operating cash flows of an enterprise—distortions that cannot be remedied solely by improvements in footnote disclosures. Others believe that the anomaly and related reporting distortions were a contributing factor to the stock market bubble, the severity of the subsequent crash, and some of the recent high-profile corporate reporting scandals and subsequent bankruptcies.

Others believe that the anomaly encourages enterprises to issue an excessive amount of fixed plan employee stock options resulting in an opaque transfer of economic value from shareholders to employees. Some studies have shown that in order to maintain their stock price in the face of such dilution, companies expend large amounts of cash on stock buybacks that have absorbed much of their free cash flow. The result is that there is less

cash available for other purposes, such as research and development, employee training, or other corporate activities, which may be more beneficial to the long-term value of the company and its shareholders.

Others, including prominent compensation experts, believe that the anomaly discourages companies from utilizing other forms of equity-based compensation that may be more beneficial to the long-term value of the company and its shareholders and that may have better incentive properties in terms of attracting, motivating, and retaining employees, than fixed plan employee stock options. Examples often cited include performance-based options and restricted stock.

The ultimate goal of the current FASB project on improving the accounting for equity-based compensation is to develop and put in place a standard that results in reporting that more faithfully reflects the underlying economic effects of equity-based compensation arrangements and that brings about greater comparability of reporting in this important area. The project also provides an opportunity to achieve greater international convergence of accounting standards, an objective the FASB has been encouraged to pursue by the Sarbanes-Oxley Act of 2002 ("Act"), the US Securities and Exchange Commission ("SEC"), and many other parties.

On March 31 of this year, the Board issued, by unanimous vote, an Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"). The Proposal is the result of an extensive public due process that began in November 2002 before the project was added to the Board's agenda. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, the review of relevant research studies, consultation with our advisory councils and valuation and compensation experts, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of the financial reports of small businesses, and active deliberations at 38 public Board meetings at which the provisions of the Proposal were carefully developed with consideration given to all interested parties.

Based on our extensive public due process to date, the Board believes that the Proposal would improve the financial reporting for equity-based compensation arrangements. We believe that by creating greater transparency, completeness, and a more level playing field in the accounting for different forms of equity-based compensation, the Proposal would enhance the comparability of reported results between enterprises that choose to compensate their employees in different ways. The Proposal would achieve that through a number of provisions, including by eliminating the existing anomaly for fixed plan employee stock options, which, as indicated above, are the only form of equity-based compensation that is not currently required to be reported as an expense in the financial statements. The Proposal also includes provisions that we believe would improve the transparency of the effects of equity-based compensation on reported cash flows.

The Proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such and that the existing anomaly for fixed plan employee stock options results in reporting that not only ignores the economic substance of those

transactions but also distorts reported earnings, profitability, and other key financial metrics. Thus, under current US GAAP, the greater the use of fixed plan employee stock options, the greater the distortion of reported results. In contrast, this distortion does not occur when enterprises use stock options, or similar instruments such as stock purchase warrants, for purposes other than compensating employees, for example, in acquiring goods or services or in financing or merger and acquisition transactions. In those cases, current US GAAP does require that stock options or warrants be valued and accounted for in the financial statements.

The Proposal would bring about greater comparability between the over 575 companies that have voluntarily opted to account for the cost of employee stock options and many others that have elected not to do so. It also would be responsive to the growing number of companies, including major technology companies, whose shareholders by a majority vote have approved nonbinding proxy resolutions mandating expensing of all employee stock options. Management of a number of those companies has indicated that it is awaiting completion of our project in order to respond to the demands of its shareholders.

The Proposal also would result in substantial convergence in the accounting for equity-based compensation between our standards and international accounting standards that will, beginning next year, be followed by companies in over 90 countries around the world. In addition, Canada, who often has followed the lead of the US in improving accounting standards, felt that it could not wait on this topic, and decided to mandate expensing of employee stock options beginning in January of this year. It is our understanding that implementation of their new standard has to date gone very smoothly.

Finally, and most importantly, improvements in accounting for equity-based compensation can have economic consequences. More credible, comparable, and transparent financial information about equity-based compensation transactions can enhance the efficiency of capital allocation in our markets. Efficient allocation of capital is critical to our nation's economy.

The Board continues to actively seek input about the Proposal from interested parties. For example, the Board discussed the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee on May 11. The Board also plans to hold public roundtable meetings with valuation and compensation experts, and users, auditors, and preparers of financial reports in the coming days to discuss a broad range of issues about the Proposal.

Following the end of the Proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the Proposal. Those redeliberations will include careful consideration of the ongoing input received from all interested parties.

Only after carefully evaluating the input and potential improvements to the Proposal at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.

Mr. DINGELL. I thank you. I also ask unanimous consent that a fine op-ed article by Warren Buffett and a statement by FACTS, the Financial Accounting Coalition for Truthful Statements, which is a coalition of over 30 pension funds, consumer/investor groups, and labor unions who oppose this bill and support FASB's proposal, also be inserted into the record.

Mr. STEARNS. By unanimous consent, so ordered.

[The information referred to follows:]

[Tuesday, July 6, 2004—The Washington Post]

FUZZY MATH AND STOCK OPTIONS

By Warren Buffet

Until now the record for mathematical lunacy by a legislative body has been held by the Indiana House of Representatives, which in 1897 decreed by a vote of 67 to 0 that pi—the ratio of the circumference of a circle to its diameter—would no longer be 3.14159 but instead be 3.2. Indiana schoolchildren momentarily rejoiced over this simplification of their lives. But the Indiana Senate, composed of cooler heads, referred the bill to the Committee for Temperance, and it eventually died.

What brings this episode to mind is that the U.S. House of Representatives is about to consider a bill that, if passed, could cause the mathematical lunacy record to move east from Indiana. First, the bill decrees that a coveted form of corporate pay—stock options—be counted as an expense when these go to the chief executive and the other four highest-paid officers in a company, but be disregarded as an expense when they are issued to other employees in the company. Second, the bill says that when a company is calculating the expense of the options issued to the mighty five, it shall assume that stock prices never fluctuate.

Give the bill's proponents an A for imagination—and for courting contributors—and a flat-out F for logic.

All seven members of the Financial Accounting Standards Board, all four of the big accounting firms and legions of investment professionals say the two proposals are nonsense. Nevertheless, many House members wish to ignore these informed voices and make Congress the Supreme Accounting Authority. Indeed, the House bill directs the Securities and Exchange Commission to "not recognize as 'generally accepted' any accounting principle established by a standard setting body" that disagrees with the House about the treatment of options.

The House's anointment of itself as the ultimate scorekeeper for investors, it should be noted, comes from an institution that in its own affairs favors Enronesque accounting. Witness the fanciful "sunset" provisions that are used to meet legislative "scoring" requirements. Or regard the unified budget protocol, which applies a portion of annual Social Security receipts to reducing the stated budget deficit while ignoring the concomitant annual costs for benefit accruals.

I have no objection to the granting of options. Companies should use whatever form of compensation best motivates employees—whether this be cash bonuses, trips to Hawaii, restricted stock grants or stock options. But aside from options, every other item of value given to employees is recorded as an expense. Can you imagine the derision that would be directed at a bill mandating that only five bonuses out of all those given to employees be expensed? Yet that is a true analogy to what the option bill is proposing.

Equally nonsensical is a section in the bill requiring companies to assume, when they are valuing the options granted to the mighty five, that their stocks have zero volatility. I've been investing for 62 years and have yet to meet a stock that doesn't fluctuate. The only reason for making such an Alice-in-Wonderland assumption is to significantly understate the value of the few options that the House wants counted. This undervaluation, in turn, enables chief executives to lie about what they are truly being paid and to overstate the earnings of the companies they run.

Some people contend that options cannot be precisely valued. So what? Estimates pervade accounting. Who knows with precision what the useful life of software, a corporate jet or a machine tool will be? Pension costs, moreover, are even fuzzier, because they require estimates of future mortality rates, pay increases and investment earnings. These guesses are almost invariably wrong, often substantially so. But the inherent uncertainties involved do not excuse companies from making their best estimate of these, or any other, expenses. Legislators should remember that it is better to be approximately right than precisely wrong.

If the House should ignore this logic and legislate that what is an expense for five is not an expense for thousands, there is reason to believe that the Senate—

like the Indiana Senate 107 years ago—will prevent this folly from becoming law. Sen. Richard Shelby (R-Ala.), chairman of the Senate Banking Committee, has firmly declared that accounting rules should be set by accountants, not by legislators.

Even so, House members who wish to escape the scorn of historians should render the Senate's task moot by killing the bill themselves. Or if they are absolutely determined to meddle with reality, they could attack the obesity problem by declaring that henceforth it will take 24 ounces to make a pound. If even that friendly standard seems unbearable to their constituents, they can exempt all but the fattest five in each congressional district from any measurement of weight.

In the late 1990s, too many managers found it easier to increase "profits" by accounting maneuvers than by operational excellence. But just as the schoolchildren of Indiana learned to work with honest math, so can option-issuing chief executives learn to live with honest accounting. It's high time they step up to that job.

The writer is chief executive officer of Berkshire Hathaway Inc., a diversified holding company, and a director of The Washington Post Co., which has an investment in Berkshire Hathaway.

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# FACTS

**Financial Accounting Coalition for Truthful Statements**

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FOR IMMEDIATE RELEASE
**COALITION CALLS ON CONGRESS TO ALLOW FASB TO ISSUE RULE ON EXPENSING STOCK OPTIONS**

Washington D.C., May 19, 2004 -- The Financial Accounting Coalition for Truthful Statements (FACTS) released a statement today asking Congress to stay out of the Financial Accounting Standards Board's process for considering a proposed rule requiring companies to expense all stock options. FACTS is a broad coalition of 30 pension funds, consumer/investor groups and labor unions advocating fairness and transparency in financial reporting. (See attached Statement for list of members.)

FACTS, which represents millions of Americans, agrees that stock option compensation is a real expense that appropriately should be included on corporate income statements, not hidden in footnotes to financial statements. The group's spokesperson, Liz Fender, commented that "Congress interfered with FASB about 10 years ago and with all of the recent events that have shaken the public's trust in the financial markets, we are surprised that they are once again contemplating such a move."

The coalition believes that accounting rules are best decided not by Congress but by FASB, an independent body charged with setting accounting standards. FASB has the expertise to fully evaluate accounting issues. It has an open, independent process for considering new accounting standards.

Less than two years have passed since the Sarbanes-Oxley Act of 2002 established a mechanism ensuring that FASB would be independently funded and free from any pressures from special interest groups. HR 3574/S. 1890, "The Stock Option Accounting Reform Act," undermines this important reform by allowing Congress to succumb to pressure from special interests and override FASB's independence.

# FACTS

**Financial Accounting Coalition for Truthful Statements**

## OPPOSE H.R. 3574/S. 1890--OBJECTIVITY, NOT POLITICS, SHOULD DETERMINE STOCK OPTIONS REPORTING

- We speak for the millions of ordinary Americans who want fairness and accuracy in financial reporting about corporate performance.
- Many that we represent have already lost confidence in companies that have violated or manipulated accounting requirements. If the Congress sides with special interests to interfere with improving standards, their confidence will be further shaken.
- H.R. 3574/S. 1890, "The Stock Option Accounting Reform Act," would establish the dangerous precedent of Congress intervening to substitute special interest provisions in place of standards that are set independently and objectively to achieve accurate and transparent financial reporting.
- H.R. 3574/S. 1890 would inject Congress directly into the accounting standard-setting process by mandating which stock compensation should be expensed and by what methodology, as well as establishing special exemptions for small businesses. Nothing could be farther from the independence for FASB to set accounting standards that Congress established in the Sarbanes-Oxley Act.
- FASB's role is to insure that companies provide transparency and accuracy in accounting standards. FASB designs the ruler. It is for others to decide what to do with the measurements.
- Stock option compensation is a real expense. Excluding stock options distorts reported earnings and misleads the public about true financial performance of companies. Excluding stock options also invites excessive executive compensation, to the detriment of shareholders, and employees.
- Growing numbers of shareholder's proposals are being adopted calling for expensing of stock-option compensation and hundreds of firms from all sectors of the economy have begun to voluntarily expense.
- Now is the time to say "no" to the special interest plea for distorted financial reporting and "yes" to the independent and objective process by which FASB determines the most accurate methods available to give information to the public.

**FINANCIAL ACCOUNTING COALITION FOR TRUTHFUL STATEMENTS**
***(FACTS)***

Amalgamated Bank
American Federation of Labor and Congress of Industrial Organizations
American Federation of State, County and Municipal Employees
Bricklayers & Trowel Trades International Pension Fund
Building Trades United Pension Trust Fund
Carpenters Local Unions and Councils Pension Fund
Central Laborers
CFA Institute (formerly the Association for Investment Management and Research)
Citizen Works
Coalition to Stop Stock Options
Consumer Action
Council of Institutional Investors
CWA/ITU Negotiated Pension Plan
Florida State Board of Administration
City of Hartford Municipal Employees Retirement Fund
Hermes Pensions Management Ltd.
International Brotherhood of Teamsters
International Corporate Governance Network (ICGN) Accounting and Auditing Practices Committee
Iowa Public Employees Retirement Systems
The Jeffrey Company
Lawndale Capital Management LLC
Missouri State Employees Retirement System
Montana Board of Investments
New Hampshire Retirement System
New Jersey Division of Investment
New York State and Local Retirement Systems
Ohio Highway Patrol Retirement System
Ohio Police and Fire Pension Fund
Ohio Public Employees Deferred Compensation Program
Ohio Public Employees Retirement System
School Employees Retirement System of Ohio
State Teachers Retirement System of Ohio
Sacramento County Employees Retirement System
TIAA-CREF
UNITE Laundry & Dry Cleaning Workers Pension Fund
UNITE National Retirement Fund
UNITE Textile Workers Pension Fund
U.S. Public Interest Research Group
Universities Superannuation Scheme
State of Wisconsin Investment Board

*(in formation)*

Mr. DINGELL. Mr. Chairman, in closing, I look forward to hearing the testimony of FASB, of GAO, and our high tech witnesses this afternoon. I am not opposed to trying to find a fair and reasonable way to address the tech industry's concerns with the FASB proposal. I ask only that at least at this time we consider that we do not fully understand what the virtues and vices of this are, nor have we heard from everybody who wishes to be heard, nor has a fair and open process been permitted to come to a proper conclusion.

It is clear to me that the Baker bill is not the answer. It is equally clear to me that it is irresponsible and improper meddling in a process which is too important to be tinkered around with by an uninformed and ignorant Congress that doesn't understand highly technical questions of this kind.

I thank you and yield back the balance of my time.

Mr. STEARNS. And I thank the gentleman.

Mr. Ferguson? Okay. Mr. Stupak?

Mr. STUPAK. Mr. Chairman, thank you. I would also like to commend Chairman Barton for his strong defense of the committee's jurisdiction over the issue before us today. The Energy and Commerce Committee has a long jurisdictional history over accounting standards and the Financial Accounting Standards Board. It is highly appropriate that we are holding this hearing, and I commend the chairman's leadership and the subcommittee chair for holding this hearing.

Today's hearing will clarify the need for the expensing of stock options, the need to keep FASB free from political and business interference, and the very real problems with H.R. 3574, the bill recently voted out of the Financial Services Committee, that would block the FASB proposal.

H.R. 3574 is evidence of exactly why Congress should leave accounting standards to the experts. Politicians are not accountants. Politicians should leave the rules of balancing the books to the experts. We can't balance our own books. Under this Congress, the United States has a debt of at least $7.1 trillion, and we will run a deficit of at least $521 billion.

For over 30 years we have trusted FASB to set accounting and reporting standards for private and public companies. Congress interfered once in that independence in 1993 when it pressured FASB to not implement a stock option expensing plan then. Had we not made that mistake, perhaps some of the excesses of the late 1990's could have been avoided.

Frankly, I think a few companies are trying to generate controversy by making red herring arguments about the FASB proposal. But a consensus among financial experts, accounting experts and consumer advocates is that the FASB proposal is needed. Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, SEC Chairman William Donaldson, Warren Buffett, and the big four accounting firms all support expensing of stock options. Over 500 companies already expense stock options voluntarily. And the International Standards Accounting Board, whose standards affect 90 countries, will require the expensing of stock options in 2005. Canada already requires it. Stock option expensing is not controversial. It is long overdue.

Finally, I would like to conclude by saying that H.R. 3574 is a deeply flawed bill. First, it applies expensing of stock options only to the CEO and the four other highest paid executives in the company, and the bill sets up a method of valuing those executives' options that doesn't make sense. When calculating the value of those options, the company is to assume that the volatility of the underlying stock is zero. Stock prices move. In fact, the greater the volatility, the greater the value of the stock option. Warren Buffett gave these two measures a flat out F for logic.

Another huge problem with the bill is that it would prohibit the voluntary expensing of options by over 575 companies that are currently voluntarily exercising their options including Wal-Mart, Ford, General Motors, Microsoft, Coca-Cola, and other innovative younger companies like Netflix. Startup companies that are expensing stock options voluntarily are often seen as more attractive investments precisely because they expense stock options. The crux of this matter is transparency. Investors have the right to receive accurate information about a company's financial health. We know too well what happens when companies cook their books. And this committee knows too well the sham accounting gimmicks used to inflate earnings and boost stock prices. Soaring stock prices allowed Enron's CEO Ken Lay to take home $123 million from exercising his stock options the year Enron went bankrupt. $123 million. Yesterday, Ken Lay was indicted on criminal charges. His indictment should serve as a reminder to Congress why this reform is needed. We should let FASB do their job.

With that, Mr. Chairman, I yield back the balance of my time.

Mr. STEARNS. I thank the gentleman.

Mr. Bass.

Mr. BASS. Thank you, Mr. Chairman, and as the Chair well knows, I welcome this hearing. I welcome this hearing in the new light, shall we say, of being able to consider before it reaches the floor an important issue, not having the jurisdiction of this committee completely obfuscated by another committee.

We have, as the Chair well knows, taken the time here to have significant hearings on this issue over the last couple of years, and the content is extremely important.

I don't want to have any of my comments be interpreted as either supporting or opposing the issue of expensing of options, because there are very good arguments on both sides, both for expensing and against expensing options, and the purpose of this hearing is to dive into those reasons or issues. And we have very good witnesses here, not the least of which is one of my classmates and former member of this committee, Rick White, from Washington.

However, as some other members of this committee have said in their opening statements, we passed a couple of years ago as a result of scandals plaguing our economy, corporate world, the Sarbanes-Oxley bill, and it contained phrases such as "independent judgment" and "free from bias" when establishing the manner in which the FASB should set standards, and to have credibility given, independent credibility given to these regulatory agencies.

Now, I have heard from many of my constituents regarding the concerns with the FASB proposal that would require expensing, and I question whether the proposed legislation which might have

been on the floor tomorrow had it not been for the leadership of our full committee chairman and the subcommittee chairman, whether this is exactly the way we should be going about it.

So I look forward to hearing the testimony of our witnesses here today, and I thank you, Mr. Chairman, not only for holding this hearing which you planned to hold quite a few weeks ago, but really working hard to make it relevant.

Mr. STEARNS. I thank my colleague.

Mr. Davis.

Mr. DAVIS. I will waive, Mr. Chairman.

Mr. STEARNS. Okay. The gentleman waives. He will have 3 extra minutes on his questioning.

Mr. Shadegg.

Mr. SHADEGG. I thank you, Mr. Chairman, and I have a full statement which I will put in the record.

I simply want to start by commending you for holding this hearing. I think it is very important that we look at this issue. I am a cosponsor of H.R. 3574, and I believe that there are legitimate concerns to be looked at here, and I think it is important that this committee examine those issues.

I personally am not fond of compelling the expensing of all stock options. I am deeply concerned that that will hurt some industries, particularly some in my own district that are technology, high-tech startups and companies that have used stock expensing to incentivize and to encourage very, very talented employees to take a risk on their companies, and have done so successfully. And I think just by dent of philosophy, I believe that everything we can do within our economic system to give employees a stake in the profitability of a company or in its success is a step in the right direction. And so I think it is important that we look at anything that would put that structure at risk. And I think stock options are a part of the structure that give employees a stake in the company.

I am concerned about the FASB proposal for a number of reasons. I am particularly concerned that there is no agreed upon method of valuation which everyone says is in fact accurate. I understand that there is consensus that there are some proposals that are more accurate than others and some sense that this might be an improvement, but I think we should, if anything, in this area go slow. And I think the Baker bill, the H.R. 3574 is a reasonable compromise in going slow in this area.

I would suggest that it is focused at the top management of the company, because those are the individuals who can in fact manipulate. And if the concern is, as one of my colleagues said on the other side, abuse of the corporation or of its financial structure through stock options, those are the individuals that would be involved in that.

I do want to make two additional points. There has always been some concern expressed that setting the volatility at zero as the Baker legislation does means we are setting the value of the option at zero, and that is clearly wrong. There are five other factors that go into the valuation of the stock. What setting at zero does is it creates a level playing field. It is both simple, understandable, and it produces consistent results which can be easily verified, accord-

ing to Frederick Cook, a FASB appointed member of the Option Valuation Group.

I think the second issue I want to address is the concern that some have that the Baker bill would prohibit companies from voluntarily expensing. As has been noted, many companies are currently doing that. I know that from my work on this legislation in the Financial Services Committee on which I also serve, that it was certainly not the intent of the authors of the bill to prohibit any company that chooses to voluntarily expense its stock from doing so, and that it is at least the belief of Mr. Baker and the authors of the bill that it in fact does not prohibit any company from choosing to voluntarily expense all of the stock options with which they issue.

I would conclude by simply saying that in a paper entitled Expensing Options Solves Nothing, a report by Harvard business professor of Business Administration, he argued that, if anything, expensing may lead to a more distorted picture of a company's economic condition and cash-flow than current financial statements provide. I think we ought to be guided by those words. I think the Baker compromise is a reasonable compromise. I certainly believe we ought to examine these issues. And I commend you, Mr. Chairman, for doing so. But, in the interest of my constituents who are high-tech companies who believe this is a critical part of the incentives they use to make their companies viable and to compete with longstanding companies, I think it would be very—we would be ill served to not look at these issues thoughtfully, and, I hope, require expensing only where it in fact will aid the marketplace and aid investors, and not where it will harm the viability of the American economy and particularly high-techs and startups.

With that, Mr. Chairman, I yield back.

Mr. STEARNS. I thank the gentleman.

The gentleman from Ohio. Mr. Brown.

Mr. BROWN. I thank the chairman. I also wish to send birthday wishes with Mr. Dingell, who shares a birthday with my mother. And Mr. Dingell, I would add, since my mother is not here to hear it, is much younger than my mother.

But the issue of if our publicly traded companies account for stock options has important implications for the integrity of corporate governance and the soundness of American financial markets, that is why as we consider whether to interfere with efforts to reform stock option accounting Congress should in fact heed the physician's maxim: First do not harm.

In 1995, as we remember, Congress overrode President Clinton's veto of legislation limiting shareholder securities lawsuits. The bill was authored by the then chairman of this committee and cosponsored by its current chairman as well as the current chairman of the Financial Services Committee. The bill was a not particularly partisan one; in fact, the veto override passed overwhelmingly. But, frankly, we got that one wrong, after Enron collapsed in 2001, leaving corporate watchdogs pointing to the 1995 laws, one contributor to a fast and loose corporate culture that spawned the Enron debacle and a string of other corporate scandals.

Today, with another reform bill before us, Congress may be preparing to repeat that mistake. H.R. 3574 derails FASB's common

sense standards, as Mr. Stupak said, for the clear, open and uniform expensing of stock options. Those standards are supported by fed Chairman Greenspan, SEC Chairman Donaldson, institutional investors like the Ohio Public Employees Retirement System, which incidentally lost $114 million to the Enron scandal.

H.R. 3574 offers the illusion, as we do so often here, of corporate accountability, because though it requires expensing of options to top corporate officers, it also effectively requires that the company place no value on those options. That bill actually undermines existing reforms by prohibiting companies, again as Mr. Stupak said, that have already begun to expense their options from continuing that practice. GM and GE, Ford, and UPS and Wal-Mart and Amazon.com and more than 500 other companies believe they can compete effectively with full disclosure, and shareholders for leading tech firms like HP, Intel, Apple, and IBM believe their interests are better served by expensing. But this bill makes that illegal.

Here is what President Clinton had to say in his veto message of the 1995 securities law: Our markets are as strong and effective as they are because they operate and are seen to operate with integrity. I believe this bill would erode this crucial basis of our market strength. Unquote.

That is just as true today as it was just about a decade ago. I look forward to the testimony of our witnesses, Mr. Chairman. I hope we can approach this important issue today and as the legislation advances with the renewed commitment to do no harm.

I yield back my time.

Mr. STEARNS. I thank the gentleman.

Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

I would like to commend our Chairman Barton for the defense of our committee's jurisdiction on this legislation in particular, and I would also like to thank you and our ranking member for holding this important hearing.

It is interesting as we hold this hearing, Ken Lay, former CEO of Enron, is in a courtroom in Houston facing charges for behavior this bill seeks to prevent. Under this bill, Ken Lay's stock options would have been fully reported. And I support entrepreneurial spirit of American companies; however, we have seen in recent years there is need to supply shareholders better information on the value of their share holdings. This bill is a step forward in achieving that goal.

The legislation provides protections from deceptive reporting of stock values and affords businesses the ability to use such options to entice the best and the brightest. Such incentives are critical to the development of technology and related industries where human capital is the driving force of the industry. Under this legislation, companies must report stock options going to the top five executives. It is the behavior of top heavy profits that has gotten many large corporations in trouble, and I believe this is a strong start in safeguarding the value of stock other shareholders possess.

And, Mr. Chairman, hopefully this is our first hearing and we are moving in the right direction with this legislation, and I yield back my time.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Thank you, Mr. Chairman.

I look forward to our hearing today on an important matter of competitiveness. The concept of using stock options as an incentive for employee performance helped contribute to substantial growth in the tech sector and brought many small businesses from infancy to mega-employer status. Having employees who have a stake in the health of the company is not only a good incentive for the employer to offer, but also a great wealth-building opportunity for wage-earners.

Now, after some high-profile bankruptcies, stock options are looked upon in a largely negative manner, and the Financial Accounting Standards Board's proposal for them to be expensed will effectively kill the goose that laid the golden egg. In anticipation of the pending accounting rule update, many companies are changing how they incentivize performance and how they report the awarding of options, I think this is an unfortunate trend.

I think we need to preserve the ability of small employers to recruit employees using incentives like stock options. It's difficult for small and start up companies to compete with large companies on salary alone. Stock options offer a potential for wealth building and an incentive for company growth.

I am also concerned with the assumption that we can predict the cost of stock option such that they can be included on a company's balance sheet. If someone could really determine what the future value of a stock is, wouldn't we all buy low and sell high?

There is another aspect to these changes that no one seems to speak about, and that is the assumption that the stock will always increase. How fair is it for a company to expense these options, then show a poor annual report as a result, then watch the stock decline to where it is worth less than the price it was granted? Certainly nobody will be exercising their options then.

I look forward to hearing from our distinguished panel on these matters today and want to continue our dialog as we tackle legislation addressing this matter. I yield back the balance of my time.

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PREPARED STATEMENT OF HON. DIANA DEGETTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Thank you Mr. Chairman. I am pleased that the members of the Commerce, Trade and Consumer Protection Subcommittee have a chance to weigh in on this very important corporate governance issue, especially given this Committee's jurisdiction over the Federal Accounting Standards Board (FASB).

In July 2002, following the revelations of alleged fraud at Enron, WorldCom and Global Crossing, the Coca-Cola Company, in an unprecedented move, began to voluntarily report the stock options it granted to its employees as an expense on its income statement. According to Coca-Cola's Chief Financial Officer, Gary Fayard, the expensing of stock options, instead of simply disclosing them in the footnotes, was the appropriate choice as doing so "more clearly reflected economic reality" and ensured "that the confidence of our shareowners was maintained."

Since July 2002, more than 500 other U.S. reporting companies, such as Exxon Mobil, General Motors, BankOne, Microsoft, Amazon.Com and Netflix, have joined Coca-Cola and started treating the stock options they give to their employees the same way they do any other form of compensation: as an expense on their income statements. Despite fears, the expensing of stock options has not led to the sky falling, stock prices plummeting or an employee exodus to China or India at any of these companies.

Recognizing that hundreds of public companies are already doing so, FASB recently released a draft rule that would require all companies to expense stock options on their income statement. The FASB rule does not prohibit companies from granting options, but only requires that they are properly accounted for.

Yet, instead of supporting FASB's efforts in crafting this long overdue rule that would be instrumental in enhancing the integrity of companies' financial statements, restoring investor confidence and strengthening corporate governance in our country, Congress, in an unprecedented move, is threatening to usurp FASB's authority and block the Security and Exchange Commission's (SEC) adoption of the FASB rule.

Such a measure would prove to be a significant step backward from Sarbanes Oxley and would call into question the commitment this body made to strengthening corporate governance only two years ago. The bill sponsored by Representative Baker would not only fail to increase financial transparency or further honest ac-

counting, but would politicize the accounting standards-setting process and would compromise the independence of FASB.

Simply stated, Congress should not legislate accounting standards nor should it interfere with the accounting standards-setting process. Not only would doing so dramatically undermine the independence of FASB, it would set a dangerous precedent. If Congress blocked the FASB rule requiring the expensing of stock options because it might adversely affect technology companies, what would stop this body from requiring FASB to change other existing rules, such as its rule on expensing depreciation that decreases the bottom line for manufacturers? While unlikely, Representative Baker's bill would open the door to such actions and potentially set us on a path down a slippery slope.

It is also important to keep in mind that the very companies who are lobbying Congress against expensing stock options for accounting purposes are expensing stock options for tax purposes. Currently, a company is able to dole out options with no impact to its bookkeeping bottom line—the one Wall Street is interested in, while simultaneously expensing options and reducing its bottom line—its tax liability—for tax purposes. Such a discrepancy not only leads to an overstatement of earnings for companies, but also a penalty to those companies who do not use options to compensate their employees. The FASB rule would rightfully correct this double standard.

Many of the companies and some Members who are against the FASB rule claim that there is no perfect way to value options and for that reason, options should not be expensed. But as Warren Buffet recently stated in a recent Washington Post editorial on the issue, "estimates pervade accounting." In fact, accountants use estimates for lots of things, including items already expensed on the income statement, such as depreciation or amortization. In fact, many accounting experts have said that the method to value stock options is much more accurate than the method to value the useful life of a manufacturing plant or a corporate jet for depreciation purposes. As Warren Buffet has admonished, "legislators should remember that it is better to be approximately right than precisely wrong."

Therefore, I commend FASB in its continued efforts to increase financial transparency and strengthen corporate governance in America. Moreover, Congress should not interfere with the accounting standard process at FASB nor should it limit the SEC's ability to recognize FASB's authority. Doing so would seriously compromise the independence of FASB, politicize the accounting standard setting-process and even more importantly, undermine Congress' efforts toward improving corporate governance in our country.

Mr. STEARNS. I thank my colleagues. We are ready for the first panel. We have the honorable David Walker, Comptroller General of the U.S. General Accounting Office. We have Mr. Robert Herz, Chairman of the Financial Accounting Standards Board. And we have our former colleague, Mr. Rick White, President and CEO of Technet, Chairman, International Employee Stock Options Coalition. And we have Mr. Steven Mayer, Senior Vice President and Chief Financial Officer of Human Genome Sciences.

From our colleagues, we have two individuals that are sort of pro stock options and we have two individuals who are not for stock options. So I think we have got a balanced hearing. And we welcome your opening statements, and we would like you, if possible, to keep them under 5 minutes, and thank you.

We will start with you, Mr. Walker. Thank you.

## STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE

Mr. WALKER. Thank you, Mr. Chairman, Members of the subcommittee. It is a pleasure to be before you here today. In addition to being the Comptroller General of the United States and head of, effective yesterday, the Government Accountability Office, still the GAO, I have been a CPA for over 30 years. So I have had to deal with these issues both in the public sector and the private sector,

the not-for-profit sector, for many years. I felt it was important that you understand my background on this issue.

I appreciate the opportunity to share GAO's perspective on the process of establishing accounting standards for private sector entities, in general, and the FASB's proposed accounting for stock options, in particular. As has been noted by a number of members, we fully recognize that the stock options accounting issue is a complex and controversial issue on which reasonable people can and do disagree.

On June 28, 2004, I sent a letter to the FASB as well as to the Chair and ranking member of the Senate Committee on Banking, Housing, and Urban Affairs. My testimony is based primarily on these two letters.

Thank you, Mr. Chairman, for putting my entire statement in the record, and I will summarize the highlights.

We support the concepts behind FASB's current proposed statement requiring that companies use the fair market value method, which essentially results in companies recording stock options and other share based compensation arrangements as an expense. In our view, stock options and other forms of share-based payments have economic value and represent a form of compensation expense. If they are not compensation, I don't know what else they are. Therefore, we believe that the economic substance of such transactions should be reflected as a compensation expense and in the calculation of a company's net income in order to accurately portray its financial results.

The current standard, which permits companies to choose between the intrinsic and fair market value methods, in effect allows companies to select their own net income. It also creates a barrier to comparable financial information, both domestically and internationally, because the choice of methods will result in differences in reported amounts across companies due to the different methods of accounting. We believe that a requirement to expense stock options and other share-based payments will provide additional transparency, clarity, and comparability in financial reporting.

I would also note, as certain other members of the subcommittee have stated, it would also serve to increase consistency between accounting and tax treatment for share based payments.

We also support the four principal reasons that the FASB has cited for issuing the new proposed standard. Notwithstanding ours and others' views on the merits of various accounting methods for stock options, we believe that the principle of independence, both in fact and appearance, with regard to standard setting is absolutely crucial. It is essential to the credibility of and confidence in the authoritative standard setting process. FASB, in carrying out its standard setting activities, has an established process in place to obtain and consider feedback from its constituent groups, including financial statement preparers, auditors, institutional investors, lenders, creditors, professional analysts, and various other parties. This process is especially important given the complexity and controversial nature of some accounting standards, including the one being considered today, accounting for stock options and other share-based payments.

We believe it is critical that the FASB complete its analysis of comments received on its exposure document on share-based payments and finalize its proposed statement in accordance with the established independent standard setting process. In our opinion, the FASB's independent standard setting process, subject to SEC oversight, which the Congress properly enacted, should be allowed to proceed in its consideration of accounting for stock options.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions after my fellow panel members have a chance to speak. Thank you.

[The prepared statement of Hon. David M. Walker follows:]

PREPARED STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE

Dear Mr. Chairman and Members of the Subcommittee: I appreciate the opportunity to discuss with the subcommittee GAO's perspective on the process for establishing accounting standards for private-sector entities and then, more specifically, the current proposals for accounting for stock options. We recognize that accounting for stock options is a complex and controversial issue on which reasonable people can and do disagree. As a result, in light of the Financial Accounting Standards Board's (FASB) current proposed standard for accounting for stock options and other share-based compensation, there has been a renewed interest for the Congress to possibly legislate accounting rules for stock options. On June 28, 2004, we sent a letter to FASB commenting on its proposed standard and a letter discussing the accounting standard-setting process to the Senate Committee on Banking, Housing, and Urban Affairs.[1]

FASB is a non-governmental organization empowered to establish financial accounting and reporting standards for private-sector entities. Although this function legally resides with the Securities and Exchange Commission (SEC) for public companies as part of its mandate to administer and enforce the provisions of the federal securities laws, the SEC has traditionally relied on FASB since 1973 to fulfill this function. The U.S. capital markets depend on a system of continuously improving financial information about the underlying economic activities of companies. This information is fostered and framed by independently established financial accounting and reporting standards, collectively referred to as generally accepted accounting principles (GAAP).

On March 31, 2004, FASB issued an exposure document on a proposed Statement, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95,* which addresses the accounting for compensation to employees in the form of stock options and other forms of equity. The FASB's proposed Statement would generally eliminate the ability for public companies to account for share-based services using the intrinsic method (which generally results in no expense being recognized) and would require instead the use of a fair-value-based method, which would generally result in companies treating stock options granted to employees as an expense based on their fair value when granted.[2] It is important to note that in 1995, when issuing the current standard that is in place, FASB clearly stated that the fair market value is the preferable method. The current standard also includes guidance to that effect and requires that if the fair market value method is not used, then disclosure must be made of pro forma net income and earnings per share presented as if the fair market value method had been used.

We support the concepts behind FASB's current proposed Statement requiring companies to use the fair market value method, which essentially results in companies recording stock options and other share-based arrangements as an expense. In our view, stock options and other forms of share-based payment have economic value and represent a form of compensation expense. Therefore, we believe that the economic substance of such transactions should be reflected as compensation expense in the calculation of a company's net income to accurately portray its financial results. The current standard, which permits companies to choose between the in-

[1] U.S.General Accounting Office, *Independent Standard-Setting Process for Establishing Accounting Standards for Private-Sector Entities,* GAO-04-480R (Washington, D.C.: June 28, 2004). This letter contained as an enclosure our comment letter to FASB.

[2] The proposed standard would permit nonpublic companies to measure compensation costs based on the intrinsic method of accounting at each reporting date until options are exercised or otherwise settled.

trinsic and fair value methods, allows companies to select the impact on net income. It also creates a barrier to comparable financial information, both domestically and internationally, because the choice of methods used will result in differences in reported amounts across companies due to the different methods of accounting. We believe that a requirement to expense stock options and other share-based payment will provide additional transparency, clarity, and comparability in financial reporting.

We also support the four principal reasons FASB cited for issuing the new proposal: (1) addressing concerns of users and others that the use of the intrinsic value method results in financial statements that do not faithfully represent economic transactions and can distort the financial condition and operations of the issuer; (2) improving the comparability of reported financial information through the elimination of alternative accounting methods; (3) simplifying U.S. generally accepted accounting principles by requiring the use of a single method of accounting for share-based payment; and (4) enabling international convergence and greater international comparability in the accounting for share-based payment.

Notwithstanding our and others' views on the merits of various accounting methods for stock options, we believe that the principle of independence, both in fact and in appearance, is essential to the credibility of and confidence in any authoritative standard-setting processes. With respect to the role of FASB in this and other areas, we support its efforts, as the SEC's designated independent non-governmental standard-setting body, to identify issues for consideration, prepare exposure documents, conduct outreach efforts and solicit comments on exposure documents, and consider the resulting comments in finalizing and issuing new accounting standards. FASB, in carrying out its standard-setting activities, has an established process in place to obtain and consider feedback from its constituent groups, including financial statement preparers, auditors, and users such as individual investors, institutional investors, lenders, creditors, professional analysts, and various other parties. These processes were established in order to balance the competing interests and demands of the various groups while providing standards that promote transparent, credible, and comparable financial information. This time-tested and proven deliberative process has served to strengthen financial reporting and ensure general acceptance of the nation's accounting standards. This process is especially important given the complexity and controversial nature of some accounting standards, including the accounting for stock options and other share-based payments.

We believe it is critical that FASB complete its analysis of comments received on its exposure document on share-based payment and finalize its proposed Statement in accordance with its established independent standard-setting process. In enacting the Sarbanes-Oxley Act of 2002, the Congress recognized the importance of having an independent standard-setting process that facilitates accurate and effective financial reporting and protects investors. As a safeguard, the Act specified criteria for the SEC to use for determining whether a private-sector accounting standard setter's principles will be considered as generally accepted. The SEC determined that FASB met the statutory criteria established in the Sarbanes-Oxley Act of 2002. In our opinion, the FASB's independent standard-setting process, subject to SEC oversight, should be allowed to proceed in its consideration of accounting for stock options.

I would like to add that GAO is involved in setting government auditing standards and accounting standards for federal agencies. We have also implemented deliberative processes to obtain and consider the perspectives of affected parties on exposure drafts of proposed standards. Standard setting is, by its nature, an iterative process and the standard setter needs a high degree of independence to make decisions on what represents the best standard in the public interest.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions you or other members of the subcommittee may have at this time.

For further information regarding this testimony, please contact Jeanette M. Franzel, Director, Financial Management and Assurance, at 202-512-9471 or franzelj@gao.gov. Michael C. Hrapsky also made key contributions to this testimony.

Mr. STEARNS. Mr. Herz.

## STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you, Chairman Stearns, Ranking Member Schakowsky, and members of the subcommittee. I am very pleased to appear here today. I think this is a very important and timely

hearing. I have brief prepared remarks and a full text of testimony, which I would request be entered into the record.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. HERZ. As you well know, our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission. The standards we produce are essential to the growth and stability of the U.S. economy, because creditors, investors, and other consumers of financial information rely heavily on credible, transparent, comparable, and unbiased financial reports. Financial accounting reporting is meant to tell it like it is, not to distort or to skew information to favor particular industries, particular types of transactions, or particular political, social, or economic goals, other than the goal of sound and honest reporting.

We understand that our proposal on share based payments or equity based compensation is controversial, the subject is controversial, but we felt it very important to address the accounting in this important area for a number of reasons.

First, there was a high level of public concern expressed by investors, creditors, financial analysts, and many other parties about the need to improve the accounting in this area.

Second, the complexity and noncomparability in this lack of transparency created by the alternative accounting treatments presently available for stock based compensation.

And finally, the opportunity to achieve convergence to a common high quality international accounting standard in this important area.

Our proposal is the result of an extensive public due process, a process that began in November 2002 before the project was added to our agenda. That process included the issuance of a preliminary document for public comment, the review of hundreds of comment letters, review of relevant research studies, consultation with our formal advisory councils, and with many, many, many other parties, including users, auditors, and preparers of financial reports of small businesses, an active board deliberation at 38 public meetings.

The proposal reflects the view that all forms of equity based compensation should be properly accounted for as such, and that the existing exception for so-called fixed plan employee stock options results in reporting that not only ignores the economic substance of those transactions, but also distorts reported earnings and other key financial metrics.

As the Congressional Budget Office stated in their recent report to Congress, if firms do not recognize as an expense the fair value of employee stock options measured when the options are granted, the firms' net income will be overstated. Thus, under current accounting standards, the greater the use of fixed plan employee stock options, the greater the distortion of the reported results.

In the public arena, as mentioned, our proposal would bring about greater comparability between the over 575 companies that have voluntarily opted to account for stock options and the many others that have not yet done so. It would also be responsive to the growing number of companies, including many major technology companies, whose shareholders by a majority vote have approved nonbinding proxy resolutions mandating expensing of all employee

stock options. The proposal also would result in substantial convergence in the accounting for equity based compensation between U.S. standards and the international accounting standards that will be followed by companies in over 90 countries around the world.

As noted, our neighbor to the north, Canada, who usually follows our lead in modifying their accounting standards, felt that it could not wait in this area and decided to mandate expensing of employee stock options beginning in January 2004. I understand that implementation of Canada's new standard, which has been adopted by over 1,500 small businesses and over 500 technology companies, has to date gone very smoothly.

Now, since the issuance of our proposal for public comment, we have continued to actively solicit input and response to the proposal. In May, the Board discussed the proposal with representatives of small businesses at the public meeting of our Small Business Advisory Committee. Mr. Mayer is a member of that. Discussions focused largely on the special provisions that were in our proposal that were intended to alleviate the cost and complexity of implementing the standard for small businesses. We are very sensitive to the needs and concerns of startups and small businesses, and recognize that special provisions might be appropriate.

In June, we held four public roundtable meetings, two in Palo Alto, California, and two at our offices in Norwalk to discuss the proposal. Over 70 individuals from a broad range of companies, investors, small businesses, valuation experts, auditors, and so on, attended the meeting and gave their views. To date, the Board has also received thousands of comment letters in response to the proposal.

Beginning later this month, we will start redeliberating at public meetings the issues and comments we have gotten on the proposals. Those redeliberations will be systematic, thorough and objective and will include careful consideration of the input already received and input that we will continue to solicit throughout the process. Only after carefully evaluating at the public meetings the input received and reaching decisions on the issues raised will we consider whether to issue a final standard.

Our current plans are to complete our redeliberations and be in a position to issue a final standard in the fourth quarter of this year. So it was with great concern that I learned that the House of Representatives may soon vote on H.R. 3574, proposed legislation that if enacted would cut short, preempt and override our current efforts to improve the accounting for equity-based compensation.

We strongly oppose H.R. 3574, as we believe do most investors, analysts, accountants and many companies. That opposition is based on many conceptual and technical reasons, including, first, the proposed legislation is seriously flawed. By mandating the expensing of only those stock options held by the top five executives and stipulating an unorthodox method for valuing and accounting for those options, the proposed legislation violates fundamental concepts of economics and accounting and would legislate significant distortions in companies' reported earnings, profitability and other key financial metrics.

Second, the proposed legislation, although titled the Stock Option Accounting Reform Act, contains provisions that have exactly the opposite effect by largely preserving, protecting and perpetuating the nonexpensing of stock options that has resulted in an unlevel playing field favoring certain companies that are the greatest user of fixed plan employee stock options over other companies that have chosen to compensate their employees in different ways.

Third, the proposed legislation, as mentioned, would be in direct conflict with the expressed needs and demands of many investors and shareholders and would appear to prohibit the voluntary expensing of all employee stock options that has been adopted by over 575 U.S. companies.

Fourth, the proposed legislation would strike a real blow to the FASB's efforts to achieve timely convergence of high quality international accounting standards and is therefore directly inconsistent with the language and intent of both the Sarbanes-Oxley Act and the related SEC policy statement reaffirming the FASB as the Nation's accounting standard setter.

Fifth, the proposed legislation would raise a host of other practical and implementation issues for companies, auditors, regulators and the entire financial reporting system.

Finally, and very importantly, the proposed legislation would in our view establish a very dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to directly intervene in the independent, objective and open accounting standard setting process based on factors other than the pursuit of sound and honest financial reporting.

For those many reasons, we believe that H.R. 3574 if enacted would result in a major step backwards in the recent efforts by Congress, the SEC, the FASB and many other parties to restore public confidence and trust in the integrity of financial reporting. As Federal Reserve Chairman Greenspan recently noted, the potential enactment of H.R. 3574 would be a bad mistake for the Congress. We wholeheartedly agree.

Speaking not just for the FASB but for the millions of U.S. investors and others that rely on the integrity of financial reporting and the capital market system, I respectfully urge all of you to oppose this legislation so that we may continue our work on developing a high quality standard that will improve financial reporting in this important area.

Thank you, Chairman Stearns. I too would be happy to respond to questions.

[The prepared statement of Robert H. Herz follows:]

PREPARED STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Chairman Stearns, Ranking Member Schakowsky, and Members of the Subcommittee: I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I want to thank you for the opportunity to publicly express our concerns, and the concerns of investors, analysts, accountants, and many companies about H.R. 3574,[1] which, if enacted, will cut short and override the FASB's current efforts to improve the financial accounting and reporting for equity-based compensation.

[1] H.R. 3574, 108th Congress, 1st Session (November 21, 2004).

My testimony includes a brief overview of (1) the FASB, including the importance of the Board's independence and the ability to conduct its work in a systematic, thorough, and objective manner, (2) the process the FASB follows in developing accounting standards, (3) the basis for the Board's unanimous decision to issue a proposal to improve the accounting for equity-based compensation, (4) the input received in response to the proposal, (5) the current status of, and the FASB's plans relating to, the proposal, and (6) some observations about H.R. 3574.

THE FASB

The FASB is an independent private-sector organization.[2] We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses.[3] Those standards are essential to the efficient functioning and operation of the capital markets and the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on sound, honest, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[4] is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor.

Financial accounting and reporting is meant to tell it like it is, not to allow distortions or skew information to favor particular industries, particular types of transactions, or particular political, social, or economic goals other than sound, and honest reporting. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting standard is harmful to investors, creditors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[5]

The Policy Statement, consistent with the language and intent of the Act, also reemphasizes the importance of the FASB's independence described earlier.[6] It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[7]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"),[8] maintains active oversight of the FASB's activities.

WHAT PROCESS DOES THE FASB FOLLOW IN DEVELOPING ACCOUNTING STANDARDS?

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully

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[2] See Attachment 1 for information about the Financial Accounting Standards Board.

[3] See Attachment 2 for excerpts from recent materials about the importance of the FASB's independence and concerns about proposed legislation.

[4] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

[5] "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

[6] Sarbanes-Oxley Act of 2002, Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

[7] Policy Statement, page 5 of 8.

[8] See Attachment 1 for information about the Financial Accounting Foundation.

considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including small businesses.

Our Rules of Procedure require an extensive and thorough public due process.[9] That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. The Board makes final decisions only after carefully considering and analyzing the input of all interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.[10] Over the past two years, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures. Some of those actions were intended to increase the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses. Those particular actions include the following:

- Establishing a Small Business Advisory Committee ("SBAC") in order to increase involvement by the small business community in developing accounting standards. The SBAC, whose members represent diverse perspectives and experiences, comprises lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community.
- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.
- Making our public Board meeting announcements available to interested parties more broadly through an email subscription service.
- Making our public Board meetings available to interested parties for monitoring via web cast on our website free of charge and via the telephone at a reduced cost.
- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website.

FASB'S CURRENT PROJECT TO IMPROVE THE ACCOUNTING FOR EQUITY-BASED COMPENSATION

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to equity-based compensation. That decision was based largely on three reasons.

The first reason was the high level of public concern expressed by creditors, individual and institutional investors, pension funds, mutual funds, financial analysts, and other users of financial statements about the need to improve the financial accounting and reporting for equity-based compensation. The concern was not just about perceived abuses of executive compensation, but the broader issue of the appropriate financial accounting and reporting for equity-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists only for fixed plan employee stock options. Those users of financial statements that have been urging the FASB to eliminate the exception for fixed plan employee stock options include:

[9] See Attachment 1 for information about the FASB's due process.

[10] The Securities and Exchange Commission ("SEC") also recently reviewed the FASB's due process and concluded that "the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . ." Policy Statement, page 5 of 8.

- The Council of Institutional Investors (an association of more than 130 corporate, public, and union pension funds with more than $3 trillion in pension assets)
- Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide)
- The Office of the State Comptroller of New York (an investor, shareholder, and sole trustee of the nation's second largest pension fund at approximately $100 billion in assets)
- Moody's Investor Services
- The Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of more than 150,000 participants of the CPF)
- The Teachers Insurance and Annuity Association College Retirement Equities Fund (a financial services company with approximately $262 billion in assets under management, serving nearly 3 million education and research employees at 15,000 institutions)
- The Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies, and 6 sponsors of unit investment trusts; its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders)
- The Association for Investment Management and Research (now known as the CFA Institute, a nonprofit professional organization of 61,600 financial analysts, portfolio managers, and other investment professionals).[11]
- The American Federation of Labor and Congress of Industrial Organizations (representing 13 million of America's workers in 65 member unions)
- The Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Peterson, chairman of the Blackstone Group, former Secretary of Commerce and chairman of the Federal Reserve Bank of New York, and John W. Snow, (former) chairman, CSX Corporation and former chairman, Business Roundtable).

In 2002, President Bush announced a ten-point plan to improve corporate responsibility.[12] That plan including the following statement: "The authors of accounting standards must be responsive to the needs of investors."[13] There is no other issue on the Board's agenda on which investors have been clearer about the need for an improvement in the existing accounting standards.

The second reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was because of the complexity and noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting equity-based compensation. That lack of transparency has been magnified by the recent trend of enterprises adopting the voluntary fair value provisions of FASB Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995).[14] The trend has increased the divergence between the financial reports of enterprises that do not make wide use of employee stock options as compensation and the financial reports of those that do, and between those enterprises that voluntarily expense employee stock options and those that do not.

As indicated above, fixed plan employee stock options are the only form of employee stock options that is not required to be reported as an expense in the income statements of the enterprises that grant them. All other forms of employee compensation, including cash salaries, bonuses, fringe benefits, restricted stock, stock warrants, performance-based stock options, indexed-based stock options, employee stock ownership plans, are (and have long been) required to be reported as an expense. Moreover, when equity-based grants of any form are issued to nonemployees for goods or services, they also are (and have long been) required to be reported as an expense.

The exception for fixed plan employee stock options is clearly an anomaly in today's financial accounting and reporting. That anomaly results in an absolute and

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[11] A 2001 survey conducted by the Association for Investment Management and Research found that more than 80 percent of financial analysts and portfolio managers responding to the survey believed that stock options granted to employees are compensation and should be recognized as an expense in the income statements of the enterprises that grant them. AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows" (November 19, 2001).

[12] Ten-Point Plan to Improve Corporate Responsibility sand Protect America's Shareholders (March 7, 2002).

[13] *Id.*

[14] See Attachment 3 for a list of 576 companies that have voluntarily adopted option expensing under the fair value method.

relative distortion of profitability and other key financial metrics. The greater the use of those instruments, the greater the distortion. As indicated above, the distortion creates an unleveled playing field that inappropriately favors those enterprises that are the greatest users of fixed plan employee stock options over other enterprises that either have chosen to compensate their employees in different ways (including different forms of equity-based compensation) or use fixed plan employee stock options but have voluntarily elected to expense them.

The distortion misleads investors, particularly, but not limited to, less sophisticated investors. The overall effect is a diversion of investment and capital resources away from their most efficient employment. As Federal Reserve System Chairman Alan Greenspan stated, "[if] you don't expense stock options, then you're getting a distorted view as to what the profitability of a particular operation is, and you will get a distortion in the allocation of capital." [15] Many other economic experts that have reviewed this issue agree, including former Federal Reserve Chairman (and current chairman of the Trustees of the International Accounting Standards Committee Foundation) Paul A. Volcker,[16] Nobel Prize winning economists Robert C. Merton,[17] and Joseph E. Stiglitz,[18] the Financial Economist Roundtable,[19] the Republican Staff of the Joint Economic Committee of the US Congress,[20] the Conference Board Commission on Public Trust and Private Enterprise,[21] and the Congressional Budget Office.[22]

Many enterprises, including some in the high technology industry, that have voluntarily expensed their employee stock options have requested that the Board mandate the expensing of all employee stock options. It is also interesting to note some of those enterprises, including Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that adopting fair value expensing for all employee stock options will not result in a curtailment of those programs.[23]

The third reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was the opportunity to achieve convergence to a common, high-quality international accounting standard in this area. The International Accounting Standards Board ("IASB") issued a proposal in November 2002 that would require that all stock options be expensed at their fair value at grant date.[24] To maximize the opportunity for international convergence, the FASB concluded that it needed to consider the US accounting requirements for equity-based compensation concurrently with IASB's consideration of its proposal.

The FASB has long been committed to actively working with the IASB and other national accounting standard setters to promote international convergence of accounting standards concurrent with improving the quality of financial reporting.[25] Both the Act,[26] and the Policy Statement,[27] indicate the support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

Since March 2003, the Board has held 38 public meetings to discuss the project. Preparations for those meetings included thousands of hours of research on issues relating to the project, including the review of the results of many research studies on the topic.

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[15] Hearing of the Joint Economic Committee, US Congress, on "Economic Outlook" (April 21, 2004).

[16] Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Testimony of Paul A. Volcker (June 3, 2002), pages 3 and 4.

[17] Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004), page 2 of 3.

[18] Joseph E. Stiglitz, "The Roaring Nineties" (October 2003), pages 115-139.

[19] Statement of Financial Economist Roundtable on the Controversy over Executive Compensation (November 24, 2003).

[20] Joint Economic Committee, Republican Senate Staff, Economic Policy Research, "Understanding the Stock Option Debate," Report 107-04 (July 9, 2002), page 18.

[21] The Conference Board, "The Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation" (September 17, 2002), page 6.

[22] The Congressional Budget Office, "Accounting for Employee Stock Options," Section 3 (April 2003), pages 4 and 5.

[23] News from Carl Levin, US Senator, Michigan, "Stock Option Roundtable Dismissed as One-Sided" (May 8, 2003), page 2; Reed Hastings, "Expense It!" *The Wall Street Journal* (April 5, 2004).

[24] IASB Proposed IFRS, *Share-Based Payment* (November 2002).

[25] FASB, *Rules of Procedure* (December 1, 2002, as amended), page 2.

[26] Act, Section 108(a)(2).

[27] Policy Statement, page 4 of 8.

In addition, the Board and staff have participated in public and private discussions about the project with hundreds of individuals, including members of the Financial Accounting Standards Advisory Council, the UAC, the Option Valuation Group,[28] and other groups and organizations representing preparers, auditors, and users of financial reports. The Board also has conducted field visits with a variety of enterprises of various sizes, including small businesses, covering a range of industries to discuss issues relating to the project.

In February 2004, at a public meeting, the Board unanimously agreed to the issuance of a proposal for public comment. That proposal was issued on March 31, 2004, for a 90-day comment period.[29]

The proposal contains a detailed Notice for Recipients encouraging comments on over 20 specific issues. Attachment 4 includes the Notice for Recipients and a Summary of the key provisions of the proposal.

WHAT HAS BEEN THE INPUT RECEIVED IN RESPONSE TO THE PROPOSAL?

Following the issuance of the proposal for public comment the Board has been actively meeting with and soliciting input from valuation experts, and users, auditors, and preparers of financial reports on issues raised by the proposal. For example, on May 11, 2004, at a public meeting the Board discussed the proposal with over twenty representatives of small and medium-sized businesses at the inaugural meeting of the SBAC.

In addition, the Board held public roundtables on June 24, 2004, in Palo Alto, California, and June 29, 2004, in Norwalk, Connecticut. Over seventy individuals from a broad range of enterprises, including representatives from the high-technology industry, small businesses, valuation experts, compensation consultants, software developers, auditors, financial analysts, institutional investors, professional and trade associations, and academics participated at the four half-day public meetings.

To date the Board has received thousands of comment letters in response to the proposal. Consistent with the FASB's Rules of Procedures Board members are required to read all of the comment letters received.

The vast majority of the comment letters received in response to the proposal are form-like letters. Some of those letters are from employees of several high-technology industry companies. While heartfelt in their urging the Board not to do anything that might result in their employers' reducing the amount of employee stock option grants, they generally do not address the financial accounting and reporting issues raised by the proposal. Thousands of other form letters were received from union employees and investors expressing unqualified support for the proposal.

Excluding the form-like letters, we have many other letters from a broad range of enterprises, accounting firms, valuation experts, compensation consultants, trade and professional associations, and academics. Those letters provide detailed input on one or more of the many financial accounting and reporting issues raised by the proposal.

WHAT IS THE CURRENT STATUS OF, AND THE FASB'S PLANS RELATING TO, THE PROPOSAL?

Later this month, the Board plans to begin its public redeliberations of the proposal. The redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal. Those issues will include (1) what is the relevant measurement attribute and relevant measurement date for equity-based compensation; (2) what is the appropriate basis for attribution of compensation cost; (3) what disclosures should be required; (4) what is the appropriate transition and effective date for the new requirements; and (5) what modifications, if any, to the new requirements should be made for small businesses. For each of these issues the public redeliberations will include careful consideration of the comment letters and other input received from all parties.

The redeliberations also will benefit from the FASB staff and Board's ongoing discussion of the key issues with interested parties from a broad range of perspectives, including representatives of small businesses and valuation and compensation experts that the FASB will continue to consult with throughout the entire process. As

[28] The Board established the Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of stock options. Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraph C37.

[29] *Id.*

with virtually all FASB projects, the redeliberations will likely result in a number of changes to improve the proposal.

Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

The Board's current plans are to issue a final standard in the fourth quarter of this year. The Board, however, has no fixed deadline for issuing a final standard and will continue its public redeliberations as long as is necessary to develop a high-quality and cost-effective accounting standard that will best serve the needs of investors, creditors, and other consumers of financial reports. As with all of the FASB's activities, the SEC staff will closely monitor and oversee the Board's due process on this important project.

SOME OBSERVATIONS ABOUT H.R. 3574

As many experts have indicated, the provisions of H.R. 3574 are seriously flawed, violate fundamental concepts of financial accounting and reporting, and, if enacted, would be harmful to the overall capital market system.[30] The Board strongly opposes such an effort to block improvements to the financial accounting and reporting for equity-based compensation. That opposition is based on many conceptual and technical reasons, including the following.

First, H.R. 3574 would override the Board's independent, objective, open, and ongoing due process to make unbiased decisions on the substance and timing of improvements to the accounting for equity-based compensation.[31] As indicated above, such intervention would be in direct conflict with the expressed needs and demands of many investors and other users of financial reports. Such intervention also would appear to be inconsistent with the language and intent of the Act and the related Policy Statement, both of which were intended to enhance the independence of the FASB.

Second, H.R. 3574 would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality international accounting standards in this important area. As indicated above, such Congressional intervention would appear to be inconsistent with the language and intent of the Act and the related Policy Statement, both of which indicate support for the FASB's convergence efforts.

Enterprises in 90 countries around the world will begin to report all equity-based compensation as an expense, in a manner generally consistent with the proposal, beginning on January 1, 2005.[32] Those enterprises will join enterprises in Canada, which were required to begin expensing all equity-based compensation, consistent with the proposal, beginning in January of this year.[33] Of note, over 350 Canadian enterprises, and hundreds of other foreign enterprises that comply with international accounting standards, are SEC registrants and are required to file their financial reports in the US.

Addressing the impact of H.R. 3574 on the independence of the FASB and the convergence of accounting standards, The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, stated in recent testimony before Congress:

> I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:
>
> "Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?"

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[30] Letter from Edward Nusbaum, CEO, Grant Thornton LLP, to the Honorable Richard H. Baker, US House of Representatives (March 17, 2004), page 4; Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton; see Attachments 2 and 5 for additional comments from experts on H.R. 3574.

[31] Of note, after appearing to mandate the substance and timing of the accounting for the expensing of certain stock options in Section 2, and constraining the substance and timing of any existing or future accounting for expensing stock options in Section 3, Section 5 inexplicably states that "[n]othing in this Act shall be construed to limit the authority over the setting of accounting principles by any accounting standard setting body . . ."

[32] International Financial Reporting Standard 2, *Share-Based Payment* (February 2004).

[33] *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870 (September 2003).

"Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet the need, in a world of globalized finance, for a common set of international accounting standards?"[34]

Third, although titled the "Stock Option Accounting Reform Act,"[35] the provisions of H.R. 3574 have exactly the opposite effect by essentially preserving, protecting, and perpetuating the existing accounting for stock options that have resulted in an unlevel playing field favoring certain enterprises that are the greatest users of fixed plan employee stock options over other enterprises that have either chosen to compensate their employees in different ways.

For example, the provisions of H.R. 3574 would appear to require that only stock options granted after December 31, 2004, to the chief executive officer and the four other most highly compensated employees of certain SEC registrants be reported as compensation expense in those enterprises' income statements.[36] Thus, if an SEC registrant grants stock options to employees other than the top five executives, that compensation cost would not be reported in the enterprises' earnings.

Moreover, the provisions of H.R. 3574 would appear to require that for purposes of determining the "fair value" of the stock options granted to the top five executives the "assumed volatility of the underlying stock shall be zero."[37] It is universally accepted that a large part of a stock option's fair value is the result of volatility of the underlying stock price.[38] Thus, the amount of compensation cost for the top five executives reported in the enterprises earnings would be substantially less than its fair value.

A recent *Washington Post* editorial commented on the "top five executives" provisions of H.R. 3574, stating:

> The second problem with the bill is its illogical content. In the past, opponents of expensing options have claimed that the value of options is unknowable. But the House bill abandons that claim by requiring that companies include in their profit-and-loss statements the value of options for their top five executives. Having conceded that, however, the bill goes on to say that the cost of options granted to employees outside the top circle should be left out, implying that they cost nothing. But they do not cost nothing. In high-tech companies, which grant options generously to middle-ranking employees, the top five executives get only a small fraction of the total—less than 5 percent in the case of Intel Corp. or Cisco Systems Inc.
>
> Moreover, the House bill stipulates that companies should use an unorthodox method for valuing options that minimizes their worth. If the bill became law, the options granted by Intel last year would force it to deduct a modest $3.5 million from its reported profit—compared with the hefty $991 million it would have to deduct under the proposed FASB reform. Cisco, for its part, could report $1.1 billion more in profit if the House bill passed. Small wonder that Intel and Cisco have led the lobbying charge in favor of the legislation.[39]

The provisions of H.R. 3574 also would appear to exempt certain SEC registrants that are "small business issuers" from having to report any compensation expense for stock options granted.[40] Similarly, the provisions would also appear to exempt certain SEC registrants from having to report any compensation expense for stock options granted to employees for three years after an "initial public offering."[41] In both cases, to the extent that a qualifying SEC registrant grants stock options to its employees, the amount of compensation cost would be understated in those enterprises" reported earnings.[42]

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[34] Hearing on Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board, Before the Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs, United States Senate, Testimony of The Honorable Paul A. Volcker (April 20, 2004), page 2 of 2.

[35] H.R. 3574, Section 1.

[36] H.R. 3574, Section 2(m)(1)-(2).

[37] H.R. 3574, Section 2(m)(3)(A)-(B).

[38] Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004), page 2 of 2.

[39] "High-Tech Holdup," *The Washington Post* (June 10, 2004), page A18.

[40] H.R. 3574, Section 2(m)(4)(A).

[41] H.R. 3574, Section 2(m)(4)(B).

[42] In commenting on Sections 2(m)(4)(A) and (B), Associated Press, Business Writer, Bruce Meyerson stated: "Bizarrely, though the purpose of these two exemptions is to ensure a continued source of cheap fuel for smaller businesses to grow, the bill would also grant a free three-year pass to Google, an established Internet juggernaut which plans to sell billions worth of stock in an initial public offering," Bruce Meyerson, "Congress threatening to derail stock options reform—again," *San Jose Mercury News* (June 8, 2004), page 2 of 2.

The provisions of H.R. 3574 also would raise a host of practical and implementation issues that would likely be very disruptive to enterprises, auditors, and the entire financial reporting system. As one example, the provisions would appear to prohibit the SEC from recognizing any accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.[43]

Existing accounting standards prescribe as the preferable method of accounting for employee stock options a grant date fair value measurement approach.[44] The more than 575 enterprises that have begun voluntarily expensing all employee stock options are required to follow the preferable method.[45] That method, however, does not encompass an exercise or other settlement date measurement approach as would appear to be required by the provisions of H.R. 3574. Thus, the existing voluntary expensing of all employee stock options by more than 575 enterprises would no longer be permitted.

In addition, H.R. 3574 has a section entitled "Improved employee stock option transparency and reporting disclosures."[46] The disclosures required under those provisions, however, are not "more detailed" or as comprehensive as those disclosures required under existing generally accepted accounting principles.[47]

Moreover, the H.R. 3574 disclosures fail to include the proposed improvements to disclosures contained in the proposal responsive to the requests of many users of financial reports, including new and improved disclosures about the related income statement and cash flow effects of equity-based payment arrangements.[48]

Finally, and perhaps most importantly, H.R. 3574 would establish a dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to directly intervene in the independent, objective, and open accounting standard-setting process based on factors other than the pursuit of sound and fair financial reporting. That signal would likely prompt others to seek political intervention in future technical activities of the FASB. In recently commenting on this issue, the CFA Institute, whose members include more than 70,000 investment professionals and educators, stated:

> Politicizing the process can only work to destabilize it and will ultimately be detrimental to those investors who have the least ability to gather political influence.[49]

For all of the above reasons, H.R. 3574 would result in a giant step backwards in the recent and ongoing efforts by Congress, the SEC, the FASB, and many other parties to restore public confidence and trust in the integrity of financial reporting. As Federal Reserve Chairman Alan Greenspan recently indicated, the enactment of this proposed legislation "would be a bad mistake for the Congress."[50] I wholeheartedly agree. Speaking not just for the FASB, but for the millions of US investors, creditors, and other consumers of financial reports that rely on credible, transparent, and unbiased financial information, I respectfully urge you to oppose H.R. 3574.

## CONCLUSION

In conclusion, let me assure you that you, and the users, auditors, and preparers of financial reports, including small business financial reports, can have confidence that the Board will carefully consider the input received in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner. Our ultimate goal is to develop, with oversight by the SEC staff, an accounting standard that will faithfully report the underlying economic effects of equity-based compensation transactions and, thus, significantly improve the transparency and in-

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[43] H.R. 3574, Section 3(a).

[44] Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 11.

[45] *Id.*; see Attachment 3 for list of 576 companies that have voluntarily adopted option expensing under the fair value method.

[46] H.R. 3574, Section 4.

[47] Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (December 2002), paragraphs 2(e) and 3.

[48] FASB Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraphs C144-C156.

[49] Letter from Patricia Doran Walters, PhD, CFA, Senior Vice President, Professional Standards & Advocacy, CFA Institute, to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski, United States House of Representatives (May 10, 2004), page 3 of 4.

[50] Hearing of the Joint Economic Committee, United States Congress, on "Economic Outlook" (April 21, 2004).

tegrity of financial reporting in the US. As indicated above, the enactment of H.R. 3574 would undoubtedly have the exact opposite effect.

Thank you again, Chairman Stearns. We would welcome the opportunity to respond to any questions.

Mr. STEARNS. Thank you.

Mr. White, welcome.

**STATEMENT OF RICK WHITE, PRESIDENT AND CEO, TECHNET, CHAIRMAN, INTERNATIONAL EMPLOYEE STOCK OPTIONS COALITION**

Mr. WHITE. Thanks very much, Mr. Chairman, Ms. Ranking Member, and the other members of the committee. It is great to be back in the best subcommittee of the best committee in Congress. I see a lot of my old colleagues who have moved up several rows since I was here last time. It is really great to be here and great to have this seat before you today.

I am currently the CEO of TechNet, a group of technology executives; we are kind of a trade organization for the technology community. I am also Chairman of the International Employee Stock Options Coalition, which is a group of companies and associations representing literally thousands of companies, both technology companies and other companies that are concerned with the stock options issue.

I guess it is fair to say we frankly don't care what this committee or FASB or any other committee does with executive stock options. What we are concerned about, what we do care very deeply about is preserving the ability, the reasonable ability, to grant such options to rank-and-file workers as many companies have done successfully over the past few years.

We do support H.R. 3574. I know that is not directly the subject of this hearing. I want to address just a couple of points. I have submitted some testimony for the record. I appreciate the chairman's willingness to include that.

One issue that has come up and several members have mentioned it, and also I think Chairman Herz mentioned it several times in his testimony, is whether it is appropriate for the Congress even to be involved in this effort. I want to make sure that people understand how important it is that Congress should be involved. There are some things that we let experts decide in our society, but there are some things we don't let them decide. There are some good reasons for that. We let engineers decide how to get a spaceship to the Moon, we let lawyers decide how a contract should be written, but we don't let them decide whether we go to the Moon, we don't let them decide whether a contract should be formed. Those are decisions that we reserve to others.

The reason is that experts are great in their specific area of expertise but sometimes that high expertise may prevent them from focusing on the bigger picture. I would submit that is really the problem we have here. That is the situation I think Mr. Herz finds himself in, one that is totally understandable given his position. If you listen to Mr. Herz' testimony and follow this issue, he will tell you basically two things. No. 1, accounting should be set by the FASB because they are the experts on accounting and Congress should stay out of that effort. I think he has said that today. That

is certainly understandable from his perspective. But he will also tell you that accountants make up FASB, they understand accounting issues but they really don't understand or don't focus on anything having to do with the U.S. economy, and FASB will not consider, and I can give you 20 places where he has made this comment, will not consider the impact on the U.S. economy of whatever accounting standard it decides to implement. That is not in their expertise. He is absolutely correct. So they won't consider that.

But you put those two comments together and I think it reveals a flaw at least in the way that Chairman Herz looks at our system. He basically means we can set any accounting standard we want but there is nobody in the chain of command who has the opportunity to decide whether there is going to be a negative effect on the economy. I would submit to you that that is not a principle that this committee can live with. Congress has delegated to the SEC the right to establish accounting standards but not as a goal in itself. The point of accounting standards are to accomplish things that this committee thinks is important, not just to further accounting theory. I would submit to you that if the FASB came up with an accounting theory that made sense to accounting professors but had a really negative impact on the economy, that is something this committee would want to look at. You wouldn't want to let them do something that was esoteric and arcane and may make sense for accounting reasons but had a big impact on economy. That is something you would not want to happen.

By the same token, if Mr. Herz' committee came up with a standard for some reason that made a lot of sense to accounting professors but really was so complicated that it could only be understood by experts in accounting, I think we have all seen examples where experts sometimes tend in that direction, but if it couldn't be understood by the individual investor, the average investor, I suggest that this committee would be concerned about that. We want a system in our country where not just experts but individual investors, the common individual investor, can understand what accounting statements are all about. I think the committee would be within its rights to get involved in a case where that happened, and I would submit to you that we are in a case right here where both those things have happened and where it is very important for you to get involved.

Let me spend just a minute on each one, then I will stop so you can ask questions. From an economics perspective, let me make sure you understand the basics of our objection. If there are two companies out there, one of them owned by the chairman and one of them owned by the ranking member, that had the exact same financial performance but let's say the chairman kind of did the wrong thing and only allowed the top executive to have stock options and the ranking member decided to do the right thing, which most of us here I think would agree with, and let every employee share in the ownership of the company, even though those companies had the same financial performance, even though they had the same amount of money in the bank, even though there was no difference in the actual assets or debits owned by the corporation, the company owned by the ranking member would look worse every month, every earnings report would always look worse than the

company owned by the chairman, who actually did the wrong thing. So if we adopted the approach that FASB is suggesting to us we are basically penalizing companies every quarter for doing what we would like them to do, which is to let their employees have a piece of ownership of the company. It is a public policy incentive that is 180 degrees from what it should be. I think that is one of the things we are concerned about.

From an investors' standpoint I think you should understand that while there definitely is some difference of opinion on whether we should expense things in the first place, and I think Mr. Mayer may talk a little bit about some of those accounting issues, there really isn't any disagreement that any valuation we come up with for these stock options is going to be a very complicated formula and won't really correspond to reality. It may make sense from an abstract theoretical perspective, I think FASB would tell you that in this situation any number is better than zero, but I can tell you that if you take a number that goes through a formula, it is very complicated, some people think it is better than zero, and you deduct it from a company's earnings, the company still has the same amount of money in the bank, still is doing the same thing, but its earnings look a lot different than they would in another accounting situation. While Mr. Herz may well understand that and maybe the experts on Wall Street understand that and maybe the institutional investors have people who can re-engineer this formula and back this number out so they can see what the real economic performance is, the average investor on the street won't have that ability.

So I would say that the two biggest criticisms that we have are the very negative economic impact and the difficulty for the average investor to be able to have transparency in what is going on. We are going to end up with financial statements that distort what most people would consider the real economic performance of the company. That might make sense if there were a clear accounting consensus and there was a clear way to do it and everybody thought it had to be done. That is not the case. We are in a situation where there is a lot of controversy, and so it doesn't really make sense to go down this path.

I will reserve the rest of my remarks for questions, but thank you so much, Mr. Chairman.

[The prepared statement of Rick White follows:]

*July 8, 2004*

The Honorable CLIFF STEARNS
*Chairman*
*Commerce, Trade, and Consumer Protection Subcommittee of the Committee on Energy and Commerce*
*2125 Russell House Office Building*
*Washington, DC 20510*

DEAR MR. CHAIRMAN: Thank you for the opportunity to submit testimony on the vitally important issue of accounting for employee stock options and to voice TechNet's strong support for H.R. 3574, the Stock Option Accounting Reform Act of 2003.

The Technology Network, or TechNet, is a national network representing 200 of the nation's leading companies in the fields of information technology, biotechnology, venture capital, investment banking and law. We are proud of the role that our industries have played in the growth of the U.S. economy, due in large part to the use of broad-based stock option plans to attract and retain talented employees.

For many technical and public policy reasons, TechNet strongly supports H.R. 3574. By protecting broad-based stock option plans while requiring expensing of options granted to senior corporate officers, H.R. 3574 represents a compromise that protects American workers while addressing concerns about senior executive compensation.

Most important, the legislation will preserve broad-based employee ownership, embodied in the 14 million American workers or 13 percent of the private sector workforce who hold employee stock options. 94 percent of these stock option holders consider themselves to be middle class, lower class or working class.

The Financial Accounting Standards Board (FASB) has proposed mandatory expensing of employee stock options using valuation methods that will significantly distort financial statements in a way that threatens this trend toward broad-based employee ownership. Mandatory expensing using the Black-Scholes or binomial valuation models, as proposed by the FASB, will result in gross overvaluation of employee stock options. The resulting inaccuracies will have a tremendous negative impact on the financial statements of companies that grant options broadly. If the FASB proposal is enacted, these companies will have little choice but to severely curtail or eliminate stock options to rank-and-file employees.

The Stock Option Accounting Reform Act protects rank-and-file American employees and preserves the broad-based employee ownership that has been the hallmark of the technology industries and many other innovative companies.

H.R. 3574 also preserves our nation's international economic competitiveness. At a time when Congress is focused on domestic job creation, mandated expensing threatens U.S. innovation and economic growth. All while many of our foreign competitors are accelerating efforts to offer stock options without mandated expensing.

TechNet believes it is critical that Congress support this legislation and not stand by while the FASB creates regulations that could have significant negative economic ramifications. The FASB is engaged, perhaps inadvertently, in changing a longstanding accounting policy that has enabled employee ownership, innovation and entrepreneurship to thrive in American businesses. The FASB's accounting regulations will have a significant negative impact on economic policy in this country. Under the guise of an accounting standard, the FASB is taking action that will bring the U.S. economic model closer to that of Europe—an environment that discourages employee ownership and fails to spur innovation and entrepreneurship. The American ownership culture is one of our greatest competitive advantages as a nation.

The Stock Option Accounting Reform Act does not dictate accounting standards. The legislation preserves the American culture and tradition of broad-based employee ownership, innovation, hard work and new ideas. It simply returns to Congress the prerogative to set economic policy.

TechNet also believes strongly that mandatory expensing of all employee stock options, as proposed by the FASB, is bad accounting. We have met with the FASB to express our strong concerns with their proposal on a technical level, although with no impact.

We believe there is a strong technical record that demonstrates that employee stock options do not represent a corporate expense. There is also a strong technical record asserting that use of the Black-Scholes or binomial models, as proposed by the FASB, will result in inaccurate, unreliable and inconsistent measurement of the fair value of employee stock options.

Existing option pricing models were created to value market-traded options, which have very different characteristics than employee options. The unique features of employee stock options are not accounted for under the Black-Scholes or binomial models. As a result, the FASB's proposal will require a wide range of subjective judgments and estimates, resulting in widely divergent results depending on the subjective assumptions a company makes. Even Dr. Mark Rubinstein, Ph.D. of Finance at U.C. Berkeley's Haas School of Business, and a creator of the binomial model, raised these concerns about his own model when he testified before the FASB.

I have attached for the record several documents which describe in detail the technical problems inherent in mandatory expensing under the FASB's proposal.

In summary, we strongly urge Members of the Committee to support the Stock Option Accounting Reform Act, H.R. 3574. This legislation supports broad-based employee ownership, hard work and innovation. H.R. 3574 is a critical economic policy approach and we urge the Congress to support it.

Sincerely,

RICK WHITE
*President and CEO of TechNet*

*June 29, 2004*

MS. SUZANNE BIELSTEIN
*Director of Major Projects*
*Financial Accounting Standards Board*
*401 Merritt 7*
*P.O. Box 5116*
*Norwalk, Connecticut 06856-5116*

Re: Proposed SFAS—File Reference No. 1102-100

DEAR MS. BIELSTEIN: On behalf of the members of The Technology Network ("TechNet"), thank you for the opportunity to submit comments in response to the Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95.* We appreciate the opportunity to offer our views on this important matter.

TechNet is a national network of 200 chief executive officers and senior partners of the nation's leading companies in the fields of information technology, biotechnology, venture capital, investment banking and law. We are proud of the role that our industries have played in the growth of the U.S. economy, due in large part to the use of broad-based stock option and other equity-based incentive plans to attract and retain talented employees. Many TechNet members maintain broad-based employee stock option programs. By giving employees at all levels a chance to share in their company's financial success through equity ownership, broad-based stock option plans boost productivity and are essential to America's competitiveness and economic growth.

For reasons discussed in this letter, TechNet has serious concerns with the Board's proposal to require mandatory expensing of employee stock options. We believe that the Board's proposal would result in financial statements that substantially overstate the value of employee stock options, providing less clarity and comparability to investors. Because of this substantial overvaluation, the proposal would make it prohibitive to offer broad-based stock option plans, encouraging companies to concentrate share ownership in the hands of senior executives.

The following addresses specific issues on which the Board seeks comment.

I. RECOGNITION OF COMPENSATION COST

**Employee stock options do not constitute an expense.**

We fundamentally disagree with the Board's premise that employee stock options constitute a corporate expense. The issuance of stock options does not result in a corporate level cost that impacts net income.

Employee stock options do not represent payment for goods or services received. Rather, employee stock options represent an opportunity for employees to share ownership in the enterprise for the purpose of increasing shareholder value. They are an employee-retention device, granted with a prospective view of future employment. A promise to issue employee stock options in return for a promise to provide services in the future in no way meets the definition of a liability. The issuance of an employee stock option results in:

- No outflow or consumption of corporate assets;
- No decline in the value of corporate assets;
- No creation of a liability representing actual or expected cash outflows;

Employee stock options have a contingent or hypothetical value to the employee who receives them. However, this value is not realizable at the time of grant and employee stock options cannot be converted into cash by either the employee or the corporation. In fact, in many cases, this potential value is never realized. Further, in any event, employee stock options will never result in the expenditure of cash by the company but, in fact, have the potential to provide cash flow to the company. Just as revenues or gains are not recognized until they are realized or realizable, the grant of an employee stock option that has no realizable cost should not be considered an expense to the corporation.

We further believe that requiring a fictional income statement impact for a transaction that takes place wholly within the balance sheet is insupportable. Unlike a fixed asset, the cost of which is an expense that is recognized over its useful life, employee stock options do not generate an expense that should be recognized either immediately or over time in the income statement. In fact, employee stock options cannot be converted into cash and to the extent employee stock options are ultimately exercised, corporate assets are increased by the amount of cash that the employee must pay to exercise the option.

Expensing stock options will also result in balance sheet entries that give a grossly distorted view of a company's capital structure. When employee stock options are

expensed, the value of those options increases a company's paid-in capital in the equity section of the balance sheet by a phantom number. The company's capital structure appears altered although no money has changed hands and no stock has actually been issued, or may ever be issued. Further, because the increased expense has impacted the company's net income and therefore its retained earnings, the balance sheet is further distorted. The equity section of a balance sheet should represent real dollars invested in the equity of the company. Expensing will not only corrupt income statements, it will serve to distort already complex balance sheets, to the detriment of investors.

Recent studies of employee stock options and compensation at a comprehensive sampling of companies provides further evidence that stock options are not compensation in that they are generally not viewed by the employee or employer as compensation for labor performed and are not granted in lieu of salary compensation. In their book, *In the Company of Owners: The Truth About Stock Options And Why Every Employee Should Have Them,* Rutgers University Professors Joseph Blasi and Douglas Kruse found that, in the companies examined, average employees who held options were paid competitive wages and benefits irrespective of any options held. Options instead represent "capital income" that workers receive for sharing the risk of ownership in the corporation.

Some have argued that a corporation incurs an opportunity cost in issuing employee stock options, but generally accepted accounting principles have not required the recognition of opportunity costs. Reliable calculation of the opportunity cost associated with the issuance of stock options would clearly be impossible. And, indeed, to do so would lead to confusing results.

If employee stock options are considered an expense on the basis of opportunity costs, then companies should be able to account for the economic benefits that result from employee ownership. Amending GAAP to incorporate such costs or benefits into the financial statement would clearly lead to distortions, inaccuracies and investor confusion.

Any cost that may exist with respect to shares or options issued to employees results from the potential dilution of each investor's share of company ownership, which may increase when options are granted. This cost is already reflected in the income statement in the earnings per share (EPS) calculation. Reducing net income when employee stock options are granted will result in an inaccurate "double charge" in the financial statements.

Because the potential "cost" of issuing employee stock options is borne by existing shareholders in the form of potential dilution, we believe that the most appropriate way to reflect the so-called "cost" of employee stock options is through consistent and extensive disclosures of data regarding shareholder dilution.

The Board has suggested that financial statements include a range of subjective estimates and that the estimated valuation of employee stock options is no different. We firmly disagree with this view. The subjective nature of the inputs into the Board's proposed option valuation formulas, the unpredictable nature of factors related to employee stock options and the resulting challenges in arriving at an accurate valuation are unique to employee stock options.

Admittedly, there are uncertainties involved in measurement of other items included in financial statements including depreciation, pension and other retirement benefits and even stock options granted to third parties as compensation for prior work performed. All of these examples, however, involve costs that can be valued and assigned a definite out-of-pocket expense; or are subject to later truing up. Depreciation estimates, for example, merely represent timing issues; the cost of equipment purchased is a readily determined number. Work performed by third parties can also be assigned a market value. In the case of pension costs, companies are required to estimate total cost, but these estimates are trued up to reflect actual costs.

In contrast, there is no reliable way to estimate the value of employee stock options and the Board's proposal does not provide an opportunity to correct results to the extent they prove wrong.

**The longstanding approach embodied in FASB Statement No. 123 is an appropriate method of accounting for stock options.**

We believe that the approach embodied in Statement 123 is an appropriate method of accounting for stock options. Statement 123 recognizes that there is not consensus on whether employee stock options constitute an expense. For all investors, Statement 123 provides relevant information and supports the public policy goal of fostering broad-based stock option plans.

Investors and accounting experts have expressed considerable doubt about the accuracy of existing valuation methods include those proposed by the Board. Man-

dating that a distorted charge be incorporated into financial statements will result in significantly less clarity, consistency and reliability in financial statements. The established approach required by Statement 123 enables investors who consider the "compensation cost" a meaningful number to easily discern a hypothetical compensation charge and its impact on the financial statement.

Those who consider the "compensation cost" meaningless may ignore that cost.

II. MEASUREMENT ATTRIBUTE AND MEASUREMENT DATE

**The grant date of the option is the appropriate date for public companies to measure the compensation cost of employee stock options**

Current stock option accounting rules require that if employee stock options are expensed, they must be expensed at the date they are granted to the employee. Notwithstanding our position that employee stock options do not represent an expense, grant date is the correct valuation date because it is when the employer and the employee agree to the terms of the stock option award.

Exercise date accounting permits reliance on an actual value, rather than estimates. However, it would produce substantial swings in net income based on volatility of the underlying stock. In addition, it would have the perverse result of creating a higher expense when the stock performs well. If employee stock options were expensed at exercise, the better a company is at increasing shareholder value, the worse its reported earnings would be.

The Board previously considered and rejected expensing employee stock options at the date they are exercised. FASB also rejected the view that if employee stock options were expensed at exercise, the "cost" of the option would be the difference between the market price of the stock and the amount paid by the employee on the date the option is exercised. More recently, the International Accounting Standards Board concluded that employee stock options that are expensed, must be expensed on the grant date.

We believe that this issue has been thoroughly examined and that the Financial Accounting Standards Board and International Accounting Standards Board reached the appropriate conclusion in determining that employee stock options should be valued at grant date. Nevertheless, as discussed below, we believe the Board's current proposal is unworkable on any basis including a grant-date basis.

III. FAIR VALUE MEASUREMENT

**Use of the Black-Scholes, lattice or binomial option pricing models will not result in accurate, reliable or consistent measurement of the fair value of employee stock options.**

We concur with the Board's view that the fair value measurement should be based on observable market prices of identical or similar instruments in active markets. We do not believe, however, that estimates of fair value arrived at using existing option pricing models will be accurate and reliable. We also do not believe the Board has provided sufficient guidance to "ensure that the fair value measurement objective is applied with reasonable consistency."

Current option pricing models, including the Black-Scholes model and the lattice or binomial models, do not "reflect[ ] any and all substantive characteristics" of an employee stock option. Each of these models was created to value market-traded options. Specifically, these models do not factor in the lack of transferability of employee stock options, as discussed below in the response to the Board's proposal relative to expected life. As a result, both option pricing models result in substantial over-inflation of the value of employee stock options. The result is a material distortion of financial statements and a negative impact on the quality of financial reporting.

The Black-Scholes model, in particular, has been widely discredited as a reliable method of valuing employee stock options. The Black-Scholes model was designed to value short-term, freely tradable stock options, which have very different characteristics than employee options. Many of the unique features of employee stock options are not accounted for by the Black-Scholes model. As a result, companies that utilize this model must factor a wide range of subjective judgments and assumptions into a complex valuation formula. Predictions of a range of variables, including interest rates, stock volatility, and employee exercise behavior will determine the outcome of these calculations, resulting in widely divergent results depending on the subjective assumptions a company makes. The results will be unreliable and will defy comparability.

We commend the Board's apparent recognition that the Black-Scholes model has limitations when valuing employee stock options, reflected in the Board's preference for binomial models. However, binomial models do not address the shortcomings of

the Black-Scholes method. While the Black-Scholes method is designed to value traded options and has known limitations with respect to valuation of employee stock options, other existing valuation models have similar deficiencies. The Black-Scholes and binomial models essentially rely on the same variables: stock price, exercise price, time to exercise, risk-free rate of return and expected volatility of the underlying stock. As with the Black-Scholes model, volatility is the key input and is difficult to predict.

In addition, these existing option valuation models were designed to value freely transferable options, yet there are significant restrictions on the transferability of employee stock options. Employee stock options cannot be bought, sold or pledged. The Black-Scholes and binomial models do not incorporate a lack of marketability discount to address such restrictions.

Further, the Black-Scholes and binomial models were designed for options that are exercisable only upon expiration. Employee stock options, in contrast, typically have long vesting requirements of up to 10 years and are then exercisable for a period of time, but are worthless if the employee terminates employment prior to vesting. The Board's proposed option pricing models do not accurately account for these factors.

The Board's proposal also does not take into account restrictions that exist during the vesting period, on the basis that only instruments that vest are ultimately expensed. Again, however, a failure to discount for vesting restrictions overstates the potential value of an employee stock option.

Any potential value of employee stock options is also significantly reduced—and made difficult to estimate—by the imposition of blackout periods or trading restrictions on employees. Many companies prevent trading of employee stock options based on events such as product breakthroughs or major announcements. These blackout periods vary by individual company and by individual employee, restricting options exercise and trading opportunities for significant periods of the year. As a result, the potential value of employee stock options is reduced and made substantially more difficult to estimate.

In short, although the binomial models may have theoretical advantages over the Black-Scholes method, in practice, they suffer from similar shortcomings. Binomial models contain a complex series of subjective inputs, and values calculated are greatly influenced by the many assumptions and choices made. Investors and other users of financial statements will have no way to understand the complex process of arriving at employee stock option valuations, nor will they be able to interpret or compare the resulting financial statements.

**Volatility estimates have a material negative impact on financial statements that do not accurately reflect a company's actual financial performance.**

The Board seeks comment on whether a specific method for estimating volatility should be used and if so, what method should be used and why. We believe that current option pricing models, including those proposed by the Board, favor companies in non-volatile industries and penalize companies in highly volatile industries. In addition, these models do not produce reliable and comparable results in large part because they require assumptions of expected volatility.

The Black-Scholes and binomial valuation models create a disadvantage for companies in volatile industries. Assuming stock price and other terms are the same, if the stock price is declining in the volatile market and staying constant in the non-volatile market, the option value will be significantly higher for the company in the volatile market, under the Black-Scholes formula.

In addition to creating a disadvantage for companies in volatile industries, the Board's proposal requires estimates of long-term volatility, inherently unreliable figures. The volatility of the underlying stock expected over the life of the option, up to ten years, is perhaps the most significant prediction that must be incorporated into option pricing models. Volatility estimates have the potential to result in substantial swings in stock option valuation yet corporate estimates of future stock volatility truly represent efforts to predict the future.

Rather than rely on historical volatility, the Exposure Draft requires companies in most instances to consider the extent to which "future experience is reasonably expected to differ from historical experience." Companies are further required to estimate future volatility over the life of the option, up to 10 years in the future.

Wide shifts in volatility are a unique feature of technology and high-growth companies, in contrast to many other sectors of the economy with more predictable performance characteristics. The high technology and biotechnology industries are subject to significant swings in volatility due to patterns of scientific breakthrough and innovation that uniquely characterize these industries. Furthermore, these techno-

logical and scientific breakthroughs or setbacks by a company—or by its competitors—are impossible to predict.

These unpredictable events also have an unpredictable impact on volatility. Experience illustrates that positive events, including strong test results, regulatory approvals and technology breakthroughs, can but do not always increase volatility. In addition, macroeconomic variables and general market conditions also positively or negatively impact volatility. Finally, the start and end dates or time period used to calculate volatility as well as the number of data points used can significantly impact the resulting volatility estimate. In short, events and their impact on volatility are not possible to predict and positive or negative events can instantly make obsolete any valuation assumptions made at grant date.

Incorrectly estimating the impact of volatility can cause option valuation and expenses to fluctuate significantly. For example, using the Black-Scholes formula and making reasonable assumptions about stock price, option life, risk free rate of return and number of option grants per year, an estimated volatility of 60 percent yields an estimated options expense number that is almost 100 percent greater than the expense number that results from a 40 percent estimated volatility. Changes in volatility estimates have a dramatic, material change in employee stock options expense, reported earnings and potentially to stock price.

Without a consistent or standardized method of estimating expected volatilities, similar companies can generate significantly different expense results. Estimates or predictions of volatility based on events a decade in the future and any valuation based thereon will clearly be unreliable, except in the case of companies that grant stock options sparingly (any expense number would be immaterial for companies with limited option programs). We urge the Board not to adopt a proposal that will create an unequal playing field by penalizing industries that experience high stock volatility.

**Employee exercise behavior is another significant factor that cannot be accurately estimated.**

The Board's proposal permits use of expected option term rather than maximum term as a means of addressing the absence of a market for employee stock options. The Board's proposal, however, would require companies to forecast employee exercise behavior. Many variables impact employee decisions to exercise stock options, including vesting horizon, option term, magnitude of in-the-money position, and the portfolio of options that the employee can exercise in the near and long-terms. In addition, employee exercise behavior differs based on job classification levels, gender and age, restrictions on trading due to blackout periods and closed trading windows, and a range of other factors. Personal decision-making based on individual expectations and needs is virtually impossible to predict, yet the Board's proposal would require such estimates.

**The unique attributes of employee stock options are not taken into account by the Board's proposal resulting in overstatement of the value of employee stock option grants.**

The Board's proposed valuation models do not provide a sufficient discount for the unique features of employee stock options. Shortening the life of an option by adjusting the contractual terms for expected early exercise and post-vesting employment behavior does not adequately account for the non-transferability attribute and other unique features of employee stock options, resulting in overstatement of the value of employee stock options.

Adjusting the "life" of the option from the contractual life may account in part for the fact that employee stock options vest. However, this adjustment does not address the other restrictions that exist including the fact that an option cannot be transferred, hedged, pledged, or sold. As a result, many options expire unexercised because an employee left a company before the options had vested or because the option price was above the price of the stock when the options became exercisable. In short, the option pricing models proposed by the Board do not address these features of employee stock options and thus will result in significant over-inflation of the value of employee stock options.

As a result of these shortcomings, current option pricing models, including those proposed by the Board, allow a corporation to come up with huge differences in the expense number depending on the inputs that are used. By failing to account for the restrictions and other characteristics of employee stock options, current option pricing models produce unreliable and misleading results that overstate the value of employee stock option grants, particularly with respect to companies in volatile industries.

A recent study confirmed that the Black-Scholes model systematically overstates the value of employee stock option grants.[1] In a detailed study of the leading valuation models applied to an actual set of employee stock option grants covering 403 million options granted by nine major U.S. companies, the Black-Scholes model consistently overstated the value of the option grants. The authors of the study cited the failure of the Black-Scholes model to consider the unique features of employee stock options.

**The Board's proposal does not provide sufficient flexibility to permit the use of new option pricing models when and if developed.**

The Exposure Draft indicates that the Board seeks to adopt a flexible standard that will permit the use of new option pricing models when, and if, developed. We are concerned, however, that the Board's proposed standard appears to preclude the use of any model that is not based on the Black-Scholes model or a lattice model. Not only must any model used rely on the Black-Scholes inputs, but the Board's proposal refers only to lattice and closed and models such as Black Scholes and there is no clear guidance on the use of alternative models once developed. We are concerned that, as a practical matter, new models could not be used unless they were derivations of Black-Scholes or binomial models.

**We have significant concerns about the Board's proposal to require options that vest on a graded schedule to be valued and accounted for separately.**

In essence, the Board's proposal would require that where options vest on a "graded schedule," that each set of options constitutes a separate award that must be valued separately and accounted for separately. Additional issuances to, for example, new employees, also would presumably have to be accounted for separately to the extent they were issued other than on a company-wide grant date. The result would be multiple valuations for the same option grant and unnecessary complexity resulting in major implementation costs and challenges.

In addition, this approach will result in inappropriate front-loading of the option expense. Under the Board's proposal, the expense of new option grants is based on "graded vesting" which accelerates the expense in the early years. Thus, there is likely to be a greater financial statement impact, or front-loading of the expense, in the first few years as each year will carry a ratable piece of the historical grants and an accelerated portion of the new grants. This would be extremely difficult to administer and impact comparability of financial statements.

**The Board's proposed transition rules would result in unreliable and incomparable financial statements.**

We are concerned that the Board's proposal will result in a significant lack of comparability due to the inconsistent treatment of new option grants versus prior option grants. The Board's proposal would require unvested options to be expensed based on the Black-Scholes value that was contained in prior footnote disclosures. Newly issued options, in contrast, would be valued based on the new standard. As a result, during the transition period, outstanding options would be valued in radically different ways.

In addition, estimates of the value of grants made in prior years using the Black-Scholes method will, under this proposal, impact financial statements going forward despite recognition that these "values" are overstated. The result will be highly confusing for investors, particularly in the case of companies that offer broad-based plans.

**We believe that the Board's proposal will have a significant, negative impact on emerging growth companies and other non-public entities.**

We are particularly concerned about the impact of the Board's proposal on non-public companies given the importance of employee stock options to the success of emerging growth companies and the reliance of such companies on stock options to attract, retain and incentivize employees. Further, we believe that the subjectivity and unpredictability of the estimates required by the Board's proposal is exacerbated in the case of non-public companies.

All of the arguments outlined above apply to non-public companies. In fact, such companies will face heightened challenges in estimating the volatility of the stock that underlies the employee stock option and for which there is no market. There is no reliable data to measure volatility for most non-public companies. Estimates based on market volatility will not be reliable because company volatility is often

[1] "Valuing Employee Stock Options: A Comparison of Alternative Models," Analysis Group/Economics for Financial Executives Research Foundation.

not comparable to industry volatility. In addition, venture-backed companies often establish new industries with unpredictable volatilities.

The Board's proposal states that, where it is impossible to estimate the fair value of employee stock options, companies be required to use an "intrinsic value" method where the value is adjusted each reporting period. Non-public entities may also elect this method. We have concerns regarding the Board's proposed use of an "intrinsic value" method in which the value of employee stock options is adjusted each reporting period.

This approach will, in effect, bring the stock price directly into the income statement. The expense associated with employee stock options will increase or decrease each quarter depending on changes in the price of the underlying stock. Under this approach, it is conceivable that the expense might even be negative in some cases.

In previous examinations of the expensing issue, the Board determined that measuring volatility would be too difficult, resulting in the current use of the minimum value method for non-public companies. We believe that estimating future volatility for new, non-public entities remains a significant challenge and we urge the Board not to require this approach.

A one-year extension of the effective date is not sufficient to address these concerns. The substantial compliance costs that would be imposed on non-public companies would far outweigh any possibly perceived benefits resulting from a mandatory expensing standard.

**The Board should conduct extensive field-testing of proposed option pricing models prior to adoption of any final standard.**

There are fundamental differences of opinion within the accounting community on the threshold issue of whether employee stock options constitute an expense. There is widespread agreement among accounting experts and in the business community, however, that current valuation models will not product accurate, reliable and consistent results. As a result, we strongly urge the Board to require field-testing of any proposed option pricing models prior to the adoption of any final standard.

Field-testing should be comprehensive and enable the financial officers and management of companies to make and test real-life assumptions to determine whether these models can produce reliable and comparable results. Further, we believe that the results arrived at through field-testing should be used to develop footnote disclosures until it can be determined that they provide accurate and reliable results. If, based on sufficient field-testing data, it is determined that the Board's proposed models provide credible, transparent, consistent, comparable and unbiased information, and that the footnote disclosure has not addressed investor needs, then the valuation of stock options on the face of the financial statements should be considered. There is ample precedent for field-testing in cases such as this, in which a long-standing method of accounting is replaced with a newer, untested approach.

**The Exposure Draft and resulting standard will not increase clarity or comparability for companies or investors.**

We support the Board's stated goal of issuing "financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence." We feel strongly, however, that the proposed Statement will not achieve this objective.

On the contrary, as detailed in this letter, we believe that the Board's proposal would establish a standard that significantly reduces the reliability, comparability and clarity of financial statements for companies and investors. We believe that the proposed standard would impose significant burdens on companies, particularly smaller companies, related to compliance and auditing. Further, we believe the standard is so complex and subjective as to produce financial statements that cannot readily be understood or compared across industries or over time by the average investor.

**The Board's proposal will have a negative impact on the ability of companies to offer Employee Stock Purchase Plans.**

The Board has taken the position that any Employee Stock Purchase Plan (ESPP) is compensatory, and an expense must be recognized, unless all holders of the same class of stock are entitled to purchase shares of stock on no less favorable terms than the employee. The proposal thus requires companies to treat as an expense the discount given to employees when they purchase shares under these plans.

Employee stock purchase plans are an important benefit to American workers. More than 15 million workers at 4,000 public companies across the United States participate in ESPPs. We are concerned that the likely result of the Board's pro-

posal will be the reduction or elimination of one of the primary savings vehicles for millions of average American employees.

IV. ECONOMIC POLICY IMPLICATIONS OF THE BOARD'S PROPOSAL

**Mandatory expensing will threaten the trend toward broad-based employee ownership**

Increasingly, employee stock options are being offered by companies in a range of industries and the clear national trend has been toward increased employee ownership particularly among non-managers. Data from the National Center for Employee Ownership and other sources over the last few years shows that the number of companies that offer options to all employees continues to grow. Currently, over 14 million American workers or 13 percent of the entire private sector workforce hold stock options, according to a recent national study by Professors Joseph Blasi and Douglas Kruse of Rutgers University's School of Management and Labor Relations and Professor Richard Freeman of Harvard University's Department of Economics. 94 percent of these employees consider themselves part of the middle class, working class or lower class, while only 15 percent identify themselves managers. Mandatory expensing will threaten this important trend.

In the high technology and biotechnology industries that TechNet represents, stock options and broad-based employee ownership have been an engine of growth, helping to build some of the nation's most innovative companies. TechNet member companies—including many of today's technology leaders as well as start-ups—have grown due in large part to the ability to use employee stock options to attract and retain skilled employees at all levels of the corporation.

A mandatory expensing standard is likely to result in the elimination of broad-based employee stock option plans. Professors Brian Hall of Harvard Business School and Kevin Murphy of the Marshall School of Business, University of Southern California, have conducted research showing that the perceived value of stock options to executives at time of grant is typically one-half to two-thirds of the value under the Black-Scholes method, and may be as little as one-third.[2] A more recent study of over 640 employees at 300 publicly-traded companies suggests that employees place a 30 to 50 percent discount on the value of stock option grants they receive, relative to the Black-Scholes value of the options.[3] If forced to absorb a cost 50 to 200 percent greater than their perceived value, companies will face a major obstacle to offering options.

For companies that broadly issue employee stock options, the inaccuracies that result through application of existing option pricing models are more likely to have a material negative impact on financial statements, while companies that issue only a small number of options—usually to senior officers—will not be as significantly affected. Under a mandatory expensing standard, companies will be forced to restrict stock option grants rather than adding a significant expense, in accounting terms, to the financial statement. The result will be a decline in broad-based stock option plans.

In fact, recent studies and press reports confirm that companies will restrict option grants if a mandatory expensing standard is adopted. A 2002 survey of 117 U.S. companies showed that most of the companies surveyed would restrict option grants to rank-and-file employees if employee stock options were required to be expensed.[4] In fact, the study suggested that four of every five companies would grant fewer employee stock options. A number of corporations have already announced plans to reduce option grants to non-executive employees in reaction to the Board's proposal.

The importance of broad-based stock options and their impact on economic growth is undisputed. Studies confirm that broad-based plans have a significant impact on productivity, innovation and economic activity. Companies that offer stock options to most or all employees have experienced significant increases in productivity.

Most recently, Professors Blasi and Kruse provide empirical evidence that companies with broad-based employee stock option plans receive a one-time, but permanent, boost to productivity of approximately 4 percent, compared to what their productivity would have been without employee ownership. Total shareholder returns increase by an average of approximately 2 percent.[5] Anecdotal evidence by employ-

[2] *The Journal of Accounting and Economics,* April 2002.

[3] How Do Employees Value Stock Options, Watson Wyatt Worldwide, March 2004.

[4] "Survey: Firms Say Expensing Would Hurt Rank-and-File,—San Jose Mercury News, describing a June 2002 study of 117 companies by iQuantic Buck.

[5] Joseph Blasi, Douglas Kruse and Aaron Bernstein, In the Company of Owners: The Truth About Stock Options (and why every employee should have them), 2003.

ees and managers in a range of industries confirm the power of stock options to motivate employees through equity ownership.

V. CONCLUSION

TechNet strongly believes that the flexible approach set forth in Statement No.123 provides appropriate information to investors. We have serious concerns that an expensing standard utilizing existing valuation methods as proposed by the Board will result in inaccurate and inconsistent financial reporting.

Existing valuation models are not adequate for valuing employee stock options. We believe that the Black-Scholes and binomial models proposed by the Board fail to adequately incorporate factors unique to employee stock options. The need to make multiple subjective determinations of the variables used in the Black-Scholes or binomial stock option valuation models will threaten the comparability and consistency of financial reporting across companies and across industries.

Thank you for the opportunity to comment on this important matter. Please contact me at (650) 213-1160 for any further discussion of our comments.

Sincerely,

RICK WHITE
*President and CEO*

Mr. STEARNS. I thank my colleague.

Mr. Mayer.

## STATEMENT OF STEVEN C. MAYER, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, HUMAN GENOME SCIENCES

Mr. MAYER. Thank you, Chairman Stearns, Ranking Member Schakowsky, and members of the subcommittee. Thank you for the opportunity to appear before you today at this important hearing. I have submitted my letter to the FASB, my comment letter and that of BIO, that I ask be included in the record.

Mr. STEARNS. My unanimous consent, so ordered.

[The material appears at the end of the hearing.]

Mr. MAYER. My name is Steven Mayer, Executive Vice President and Chief Financial Officer of Human Genome Sciences. I am a member of the Small Business Advisory Committee to the FASB, as Mr. Herz mentioned, and I did participate in the first meeting of that committee on May 11 of this year. I have been a participant in the biotechnology industry for more than 20 years and have served as Chief Financial Officer of a number of biotechnology companies, both private startups and public companies, for 19 years.

I am pleased to appear today on behalf of BIO, the Biotechnology Industry Organization, which represents more than 1,000 biotechnology companies and related organizations. Most of these companies are engaged in the search for therapies to prevent, treat and cure diseases, including cancer, cardiovascular disease, autoimmune disease, infectious diseases such as HIV/AIDS, and many other serious conditions.

At Human Genome Sciences we were a pioneer in the discovery of human genes and the application of those discoveries to human therapeutics. We are currently testing in human clinical studies breakthrough treatments for cancer, lupus, rheumatoid arthritis, hepatitis C infection, and even the potential bioterror threat, anthrax. In addition, we are in preclinical development of treatments for HIV infection and diabetes.

In all of my experience in the biotechnology industry, in every company with which I have been associated and in virtually every company with which I am familiar, stock options have played a key role in the recruitment, retention and reward of the scientists, phy-

sicians, professionals and staff. In fact, all of these companies use broad-based plans that generally extend to most if not each and every employee in the company. All of our employees at Human Genome Sciences are eligible for our stock option program.

So I have a pretty good understanding of how stock options have been used in our industry over a long period of time and an appreciation of the fact that stock options have been a key ingredient in making the U.S. biotechnology industry the world leader by a very wide margin. I am concerned that putting this structure at risk could jeopardize the important research going on in the biotech industry. That is why I am here today to speak on behalf of BIO in support of the legislation that you are considering, H.R. 3574, and to explain why I believe there are fundamental and fatal flaws in the exposure draft prepared by the FASB that would require mandatory expensing of stock options.

First, I believe mandatory expensing is bad policy that will diminish the entrepreneurial spirit of our industry, reduce the availability of capital and decrease the alignment of interests among employees, management, and stockholders. Such a change will in all likelihood have a detrimental impact on a broad range of rank and file employees who today have an opportunity to accumulate wealth through participation in the value that they help create.

Second, and most important, I believe expensing is bad accounting that will cause financial statements to become less reliable, less transparent, less comparable, more volatile, less understandable and less useful.

Some points. Employee stock options do not represent an expense as defined in the FASB's own conceptual framework, CON 6. I would encourage all the members, or perhaps their staffs, to read the conceptual framework. It is an excellent document. I commend the FASB on it. But the FASB definition of expenses in that conceptual framework states that "expenses represent actual or expected cash outflows that have occurred or will eventuate as a result of the entity's ongoing major operations." The grant, exercise or sale of shares from a stock option never under any circumstances result in a cash outflow. In fact, they may result in a cash inflow.

Another point. Expensing stock options I believe will actually distort earnings per share by double counting the impact of the option, first as an expense and then a second time as dilution. The true economic impact of issuing stock options is already fully captured in the dilution of earnings per share. It is actually the stockholders who give up a share of their interest in the company in exchange for value created, not the company that incurs an expense.

Transparency. We hear it a lot. We talk about it a lot. Transparency means that one can understand where the numbers come from and how they were derived. Few people I know understand the Black-Scholes model, including many of those who use it. No one I know understands the lattice model nor do they understand how they will come up with the many estimates required to implement it. This single number is only a theoretical estimate of a cost that is never actually incurred, that never results in a cash outflow and that may in our industry, in the biotech industry, overwhelm every other category of expense in the income statement.

This is not transparency. What we have today with extensive footnote disclosure already required by the Securities and Exchange Commission is much more transparent. The information is readily available to any investor or creditor who wishes to use it. Increasing the complexity of financial statements in this way will only make the information less accessible to the average investor, the small creditor, the independent analyst. The large institutions will have the legions of analysts needed to untangle and interpret these complex statements resulting in a less level playing field than we have today.

My third point is that the cost of implementation and the difficulties of auditing the many estimates that would be required to implement the expensing of stock options have been severely underestimated and will far exceed, in my view, any benefit that could possibly be derived from taking the extensive information already available in the footnotes to financial statements and embedding it in the income statement as a single theoretical estimate. The implementation of this new standard will be a crushing burden to many companies in our industry.

My grave concern is that the forces that are defining this new accounting approach are driven by a desire to reshape executive compensation and not by the goal of improving financial reporting. Is accounting policy the right way to address the executive compensation issue? In this setting, I am hopeful that Congress will act to preserve reporting standards that result in clear, reliable, comparable and informative financial statements.

Thank you again for this opportunity. I will be happy to answer any questions.

Mr. STEARNS. Thank you, Mr. Mayer. Let me ask you something, Mr. Mayer. From your testimony, you are saying that you would agree to expense stock options for all employees if we used the lattice model?

Mr. MAYER. No. I am saying that I think using the lattice model would be an incredible burden on companies because people don't understand it.

Mr. STEARNS. Black-Scholes, you don't think that——

Mr. MAYER. Black-Scholes is a simpler model that people currently use for doing their footnote——

Mr. STEARNS. But your position is you do not think any stock options should be expensed, is that correct?

Mr. MAYER. That is correct.

Mr. STEARNS. Mr. White, is that your position, that no stock options should be expensed?

Mr. WHITE. As a theoretical matter we don't think it makes sense to do it. As a matter of policy it may make sense to make a distinction for the top five since they do have the ability to manipulate the price of a stock.

Mr. STEARNS. So we are clear that your position is pretty straightforward that no stock option should be expensed. On the other side, Mr. Walker and Mr. Herz believe they should be. When you look at other people who have experience in this matter, I mention Alan Greenspan, Paul Volcker, SEC Chairman Bill Donaldson, Treasury Secretary John Snow and Warren Buffett, all think they

should be expensed. Both of you individuals do not agree with them. Canada is starting to expense them and so is Europe.

So at this point we also have all seven members of the Financial Accounting Standards Board, we have the four top accounting firms and legions of investment professionals that say they should be expensed. Not only that but Warren Buffett, who has had 62 years of investing, is one of the most wealthy men in the country, has pointed out in his recent editorial that he believes stock options should be expensed. The question is, in his editorial he was concerned about, and as has been pointed out by one of the members of the panel, is that the idea of zero volatility means there is no expense.

So I guess the question is, and this is for you, Mr. Herz, H.R. 3574 requires that the assumed volatility for options granted to the five highest paid executives in a corporation be zero. Mr. Buffett says that is impossible. In his 62 years he has never seen a stock that doesn't fluctuate. He calls it an Alice in Wonderland assumption to state that it would be zero.

So let me ask you a question. Can you expense a stock if its volatility is considered to be zero?

Mr. HERZ. You would get what is called the minimum value approach, which is just accounting for the discounting of the strike price, but you can actually then engineer the strike price to get a zero expense and just keep the value the same by multiplying the number of the grant of the options. The answer is that it defies all rational, proven finance logic that underlies the whole financial——

Mr. STEARNS. Let's be fair. In that bill they also have other criteria besides the zero volatility. So comment about those. Do they make it more credible?

Mr. HERZ. The bill has what is called a true-up at the end for the spread between the grant price and the value of the stock at that end, whether it is higher or lower. That is what is called exercise data counting. That is not an accounting that is supported by many accountants. It is an accounting that the CBO looked into.

Mr. STEARNS. Does FASB support the other options that are in the bill as a criteria?

Mr. HERZ. No.

Mr. STEARNS. Mr. Walker, the other criteria that is in this bill besides the zero volatility, do you find those credible to use for expensing options?

Mr. WALKER. I think they are issues that are reasonable to consider but the fact of the matter is I think it is unrealistic to not consider volatility. To a certain extent, Mr. Chairman, what I am hearing is an advocacy for social accounting.

Mr. STEARNS. What is social accounting? Define that.

Mr. WALKER. There is a big debate that happens from time to time saying that you ought to invest or not invest in certain types of things because of social or societal interests. What I am hearing from the two panel members who oppose the FASB's proposed action is that accounting shouldn't be based on economics, it shouldn't be based upon consistency and transparency and substance over form, it should be based upon what kind of social implications it might have.

I might add, as an anology, I used to be Assistant Secretary of Labor for Pensions and Employee Benefit Programs, so I am very familiar with ESOPs, employee stock ownership plans, profit-sharing plans. The Tax Code has all kinds of incentives in it for broad-based, employee-based share arrangements. It also has a number of additional flexibilities with regard to Federal laws in order to try to encourage those types of arrangements, but that is different than how you ought to account for those types of arrangements.

Mr. STEARNS. Let me just conclude. Mr. White and Mr. Mayer, you have testified that stock options should not be counted as expense because, in your words, "they represent an opportunity for employees to share in ownership." But, Mr. Mayer, don't we expense the direct grant of stocks? Aren't they expensed when I give you stocks personally?

Mr. MAYER. Yes. From an accounting treatment——

Mr. STEARNS. If it is true that we force you to expense the stocks when we give them to you, why wouldn't it be possible to expense the option for the stock?

Mr. MAYER. Stocks have certain value. If I give you a share of stock, it is liquid, you can take it——

Mr. STEARNS. And we are saying options do not have that?

Mr. MAYER. Do not have certain value. In fact that is exactly the point.

Mr. STEARNS. Doesn't the corporation go out and have to commit those at a certain price before they give it to the——

Mr. MAYER. Absolutely not. No. Typically—it depends on the company but typically the company will reserve shares.

Mr. STEARNS. That is what I mean. When they reserve those shares, isn't that a commitment by the company typically and at that point somebody owns those shares and is protecting that price value before it goes up or down?

Mr. MAYER. No, absolutely not. The shares that are reserved are set aside at the behest of the stockholders, the owners of the company, not by management, and under today's rules all stock option plans must be——

Mr. STEARNS. But who is going to buy those stocks when it is exercised?

Mr. MAYER. The public market would.

Mr. STEARNS. And who is going to guarantee that price—if you are going to buy it at 32 and it is 200, who is going to guarantee that 32?

Mr. MAYER. Well, the 32 is a contractual commitment by the company.

Mr. STEARNS. Isn't a contractual commitment an expense if it involves options of stocks?

Mr. MAYER. No, it is not an expense. In fact an expense as defined by FASB is a cash outflow. There isn't a cash outflow.

Mr. STEARNS. Let me just conclude with Mr. Herz. I am a little over my time. Yes, Mr. Herz.

Mr. HERZ. Options clearly do have value and any options are given for other purposes, to acquire goods and services, they are used in M&A transactions, stock purchase warrants are used as part of financing packages. In all those cases, it has been long established accounting that you value them and you account for that

properly. It is just this one form of employee stock option that has this kind of narrow aperture in the existing accounting literature that has been used to not account for them.

Mr. STEARNS. My time has expired.

Mr. MAYER. If I could just correct what I think is a misconception on the volatility issue. Zero volatility does not mean zero value by definition under Black-Scholes. I am less familiar with the lattice model, but you plug in zero volatility into a Black-Scholes model, you will not get zero value. You will get a lower value than if you plug in a higher volatility. In fact volatility is the most sensitive parameter and is exactly why I am so concerned about this because nobody here can predict what the stock market volatility will be over some 7 or 10 years.

Mr. STEARNS. My time has expired. The gentlelady.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman. Mr. White, I have to tell you that I was shocked and offended by what I view as the very—you don't have to put your mike on because I am going to ask Mr. Herz to respond—patronizing tone of your testimony in saying that we had to consider these larger economic questions. I want to tell you something. That is why we are here right now, the effect on the economy. If you doubt that, talk to some of these employees of Enron or other victims of corporate misconduct. The reason that we are so concerned about setting some neutral industry standards and accounting standards and looking at what FASB is trying to create here is because we have economic victims of this corporate irresponsibility and misconduct and, in the case perhaps of Ken Lay, of criminal activity. So we are looking at larger questions here.

I don't want to say too much because I saw Mr. Herz taking some notes while you were talking. I want to give him some time to respond to your patronizing testimony. But you were concerned, Mr. White, about my company not doing as well because I had to report those expenses. I just wanted to read to you, in March 2004, a leading compensation firm, Towers Perrin, issued a study examining 335 companies that switched to stock option expensing and found that stock performance was the same on average as the rest of the S&P 500 and Mid Cap 400 indices. Stock option expensing did not affect company stock prices. The same dire prediction had been made and shown to be unfounded when FASB first required companies to begin accounting for their obligations to employees relating to retiree health care benefits.

So I would say, don't be concerned about my company. Were I to expense those stock options, it appears that I would be doing just fine as these nearly 600 other companies seem to be doing, as Canada, as 90 other countries. And the idea of harmonizing what we do with the rest of the world, it seems worth commenting on as well.

I would like, Mr. Herz, to give you the opportunity to respond to some of the comments that Mr. White made regarding the inapplicability.

Let me just say one other thing. It seems to me that what you were suggesting, Mr. White, was politicizing the question of these accounting standards and it seems to me that your suggestion, rather than helping, undermines investor confidence in accounting

practices, allows companies to misrepresent their true financial positions, does not allow for honest and transparent accounting, and prevents investors and pension funds from making informed decisions. It seems to me that is what I heard Mr. Walker saying, too, I think, is if we want to establish confidence, then doing exactly what FASB, or perhaps we need more discussion about the exact nature of it, but the idea of what FASB was suggesting is the direction we ought to go.

Mr. Herz.

Mr. WHITE. You are not going to let me respond, is that correct?

Ms. SCHAKOWSKY. You took more than your time as it was and I would like now Mr. Herz to use my remaining time. If there are others who want to give you time, that would be fine.

Mr. HERZ. Thank you. Because I was going to say that I was kind of grateful to Rick for characterizing my own statements, which I think he mischaracterized some of them. On the issue of not considering the impact on the U.S. economy, our mission is exactly about—as you say, it is about the efficient allocation of capital in the economy. We think that is a huge public policy goal.

Different groups come to us, different industry groups come to us always and say, my public policy mission is the highest in the economy. We had a group from the steel industry come and quite rationally say steel needs to be made more competitive, the costs are too high, we want you to exempt us from showing pension costs. I asked, do you still have those costs? Yeah, but we want you to put it in the footnotes, make you look more competitive. When we were doing the thing on special purpose entities, we had a number of people who were purveyors of different structures saying, well, my special purpose entity is good, it allows companies by keeping it off the balance sheet to borrow more and they can hire more people and they can invest in things. We can't make those kind of decisions nor should we have to.

For us, as I said, it is about trying to get the right accounting, the issue of investors and backing the thing out. The fact is that investors, shareholders, institutional investors have all kind of voted either in resolutions or in all sorts of surveys and they all back our proposal strongly and the idea of expensing.

He said there is no clear accounting consensus. Yeah, there is some debate on some of the technical issues, but on the basic issue of expensing, as mentioned, all the accounting firms I know, not just the big four, the next two large ones, in the international arena, the International Accounting Standards Board approved their standards by 14 to nothing. On that board are people from nine different countries from all parts of the world. So I think there is a fair amount of consensus on this issue.

Ms. SCHAKOWSKY. Thank you. Mr. Chairman, I seek unanimous consent to put into the record a letter that myself and Mr. Dingell and 22 Members of the House and Senate sent to FASB and also the list of the 576 companies that have voluntarily adopted option expensing, a report from Bear Stearns.

Mr. STEARNS. By unanimous consent, so ordered.

[The information referred to follows:]

# Congress of the United States
Washington, DC 20510

June 30, 2004

Financial Accounting Standards Board
Director of Major Projects
File Reference No. 1102-100
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Sent by electronic mail to director@fasb.org

**RE: Employee Stock Option Accounting**

To Members of the Financial Accounting Standards Board:

We are writing in strong support of the Exposure Draft on Share-Based Payments, which has been proposed by the Financial Accounting Standards Board (FASB) to amend Financial Accounting Standards No. 123 and 95 on accounting for stock options. The signatories to this letter, Members of Congress from the U.S. House of Representatives and U.S. Senate, are strong supporters of an honest accounting standard that would require all employee stock option compensation to be shown as an expense on corporate financial statements.

Current U.S. accounting standards allow companies to choose whether or not to report stock option compensation as an expense in their financial statements. Many companies have chosen not to report any expense, even when claiming stock option expenses on their tax returns. Stock options are the only form of compensation expense that may be completely omitted from a corporation's financial statements. All other forms of compensation – including stock grants, stock appreciation rights, performance awards, golden parachutes, health and retirement benefits – must appear as an expense. The issue is not whether these forms of compensation provide useful incentives, but whether all of them should be reflected honestly on company financial records as company expenses.

**Stealth Compensation**

The unique and unwarranted accounting treatment afforded stock options has fueled stock option abuses linked to excessive executive pay, inflated company earnings, dishonest accounting, and corporate misconduct.

Since the 1980s, stock option compensation has funneled millions of dollars to U.S. corporate executives and contributed a substantial portion of the compensation paid to chief executive officers (CEOs) at U.S. corporations. Business Week has estimated that, in the aggregate, employee stock options now account for "a staggering 15 percent of all shares outstanding" at U.S. publicly traded corporations. In 2003, CEO pay at 350 major U.S. public companies averaged $8 million, with stock options typically providing the largest single compensation component. Stock options have frequently provided such striking sums as the $123 million paid to Enron's CEO in 2000, the $700 million paid to the CEO of a high technology company in 2001, and the $130 million paid to another CEO in 2003. At many companies, this compensation never appears on the company's financial statements as an expense, despite the size of the payment and the common practice of deducting it as an expense on the company's federal corporate tax return. At these companies, stock options have functioned as stealth compensation.

In addition to fueling excessive executive pay, the omission of stock option expenses from company financial statements, combined with the inclusion of this expense in company tax returns, have resulted in overstated earnings. Federal Reserve Chairman Alan Greenspan has stated that "[t]he failure to expense stock option grants has introduced a significant distortion in reported earnings" and estimated that, from 1995 to 2000, stock options were used to overstate reported company earnings by an average of 3 percent. Focusing primarily on high technology companies, Bear Stearns has calculated that, if companies in the Nasdaq 100 index had included stock option expenses, their reported 2003 earnings would have fallen by as much as 40 percent.

But overstated earnings are not the only accounting problem associated with stock options. A September 2002 report issued by a blue-ribbon panel established by The Conference Board found that the current accounting treatment of stock options helped "foster[] what appears to be a vicious cycle of increasing short-term pressures to manipulate earnings in order to bolster stock price in order to cash in on options." A more recent study by Texas A&M University of 100 companies that restated their financial results in 2000 and 2001, used regression analysis to determine that the factor most likely to result in a financial restatement was whether the CEO had substantial, in-the-money stock options. Stock option abuses and the dishonest accounting associated with them have damaged the credibility of not only individual companies, but also overall investor confidence in the accuracy and reliability of U.S. corporate financial statements.

In response to this loss of confidence, since 2002, nearly 600 U.S. corporations have decided voluntarily to begin expensing their stock options, including such American giants as Coca-Cola, General Motors, General Electric, Dow Chemical, Amazon.com, Home Depot, and Wal-Mart. Other companies, however, especially in the high technology sector, have announced that they will not expense stock options until required to do so, even when pressed by a shareholder majority vote to begin expensing. This division of approach means that, until FASB acts, there will be a discrepancy between those companies that are voluntarily expensing options and those that are not, when there ought to be a level playing field in which everyone operates under the same accounting

rules. Failure to correct this discrepant accounting would continue to disadvantage companies that openly report their stock option expenses and continue to hinder investors attempting to compare corporate performance.

**Consensus Position**

The position taken in the Exposure Draft in favor of stock option expensing reflects the consensus position of most accounting experts. The International Accounting Standards Board, for example, has already issued a standard requiring stock option expensing beginning in 2005. This standard will apply to companies in over 90 countries around the world, including in Europe, South America, Africa, and Asia. Canada began requiring stock option expensing this year. A 2002 survey of financial experts by the Association for Investment Management and Research found that more than 80 percent supported stock option expensing. All four of the major accounting firms in the United States, Deloitte & Touche USA, Ernst & Young, KPMG, and PricewaterhouseCoopers, also favor expensing.

Other economic, financial, and accounting leaders also support stock option expensing as good for investors and good for markets. They include Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, Securities and Exchange Commission (SEC) Chairman William Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, former SEC Chairman Arthur Levitt, former Comptroller General Charles Bowsher, investors Warren Buffett, John Biggs and Pete Peterson, Nobel Prize winners Joseph Stiglitz, Robert Merton and Myron Scholes, as well as respected groups such as the Council of Institutional Investors, the Investment Company Institute, Financial Services Forum, Consumer Federation of America, National Association of State Treasurers, Institute of Management Accountants, and The Conference Board's Commission on Public Trust and Private Enterprise.

**Opposing Arguments**

Some opponents of stock option expensing argue that, due to the difficulty of precisely estimating stock option values, expensing would confuse rather than educate analysts and investors about a company's financial condition. But financial statement users already rely on many estimated valuations called for by accounting rules, from the value of goodwill to the reserves required to protect against uncollectible receivables or loans. As Warren Buffett once said, the only value that everyone agrees is incorrect for a stock option is zero. The better approach is the one taken in the Exposure Draft, which requires use of stock option valuation methodologies that produce a reasonable estimate of stock option compensation expenses.

Some opponents warn that requiring stock option expensing would impose significant costs on new businesses and deter investment; however, evidence provided at a Senate Committee on Small Business and Entrepreneurship hearing on April 28, 2004 shows the opposite. One of the hearing witnesses, Mr. Roberto Mendoza, testified that

his startup company, Integrated Finance Limited, decided from its inception to expense all stock option compensation, and found that its stance actually attracted investors by demonstrating the company's adherence to transparent accounting. Mr. Mendoza also testified that when he determined that the company's draft audited financial statement had failed to include any stock option expense, his accountant agreed to include that expense at no additional cost and was able to calculate the expense itself in less than 20 minutes. This testimony shows that calculating stock option expenses can be quick and inexpensive, and need not be burdensome to new or small businesses.

Other opponents claim that, by lowering company earnings, stock option expensing would cause company stock prices to fall and depress investment prospects. But the facts, again, show otherwise. In March 2004, a leading compensation firm, Towers Perrin, issued a study examining 335 companies that switched to stock option expensing and found that stock performance was the same, on average, as the rest of the S&P 500 and Mid-Cap 400 indices. Stock option expensing did not affect company stock prices. The same dire prediction had been made and shown to be unfounded when FASB first required companies to begin accounting for their obligations to employees relating to retiree health care benefits.

Other financial analysts have also rejected dire predictions about depressed share prices and investment. They include Goldman Sachs Global Equity Research ("We do not expect a material impact on the share prices of most firms."); UBS Investment Research (Expensing is "medicine for the long-term health of companies and investors. It will shed light on the true profitability of many companies, helping to separate those that deserve investor capital from those that do not."); Merrill Lynch (The argument that expensing options will harm U.S. technology leadership and job creation is based on "the following faulty logic: U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements. One might as well argue that money spent on R&D shouldn't count as an expense because it provides employment and helps industries advance."); Credit Suisse First Boston Equity Research ("We expect companies to pay closer attention to the economic cost of their stock option plans. Companies don't focus much on costs that they don't have to account for."); and Congress' own nonpartisan Congressional Budget Office ("[R]ecognizing the fair value of employee stock options is unlikely to have a significant effect on the economy . . . however, it could make fair value information more transparent to less-sophisticated investors.").

Still other opponents claim expensing stock options would stifle innovation in business. But many of the nearly 600 companies currently expensing options are successful, high technology innovators like Microsoft, Netflix, and Amazon. They also include such diverse companies as Boeing, General Motors, Dow Chemical, BankOne, and UPS, each of which relies on technical innovation for business success. The CEO of Netflix, a high technology company that began expensing stock options last year, has stated: "[I]nnovation continues unabated. ... We innovate because it thrills us, not because of some accounting treatment."

Another red herring argument is that expensing would eliminate broad-based stock option plans and hurt average employees. These contentions are also contradicted by the factual record. Companies that currently offer broad-based plans to their workforce such as Home Depot, Wal-Mart, and Netflix, have already determined that they can expense options without having to terminate their stock option plans. Other companies, such as Microsoft, are replacing stock options with stock grants, thereby ensuring that their employees actually receive company stock. It is also important to remember that most U.S. employers, including many private companies, small businesses, and partnerships, don't offer stock option compensation to any of their employees, executive or otherwise. A nationwide survey conducted by the Bureau of Labor Statistics in 2000, a banner year for stock options, found that only 1.7 percent of U.S. private industry employees actually received any options during the prior 12-month period. In short, neither broad-based stock option plans nor average workers would be hurt by honest accounting.

Additional proof that stock option expensing will not hurt American business is the track record actually compiled by the nearly 600 companies that have voluntarily agreed to begin expensing. These companies represent nearly 25% of the number of companies on the Standard and Poor's index of companies and over 40% of that index based on market capitalization. None has experienced the dire consequences predicted by expensing opponents.

**Conclusion**

Honest accounting will help, not hurt, American business. Now is the time to end years of misleading accounting and recognize the expense associated with stock option compensation. FASB almost took this course of action ten years ago, but retreated due to political pressure. We urge FASB to stand firm this year and do what you think is the right thing to do. We commit to do our part by opposing legislative efforts in Congress to override FASB's judgment and politicize the accounting standards-setting process. Reversing FASB's judgment on this issue would undermine key accounting reforms strengthening FASB's independence, open the door to new Enron-style abuses, and signal that accounting maneuvers to prop up earnings are still acceptable.

Financial Accounting Standards Board
June 30, 2004
Page 6

Requiring companies to expense employee stock options will strengthen the accuracy of corporate financial statements, bring U.S. accounting standards into alignment with international standards, and help restore public trust in our financial reporting system, our companies, and our markets. We urge FASB to go forward as it has proposed and promulgate a final accounting standard to require stock option expensing beginning in 2005.

Sincerely,

John McCain

Carl Levin

Paul Gillmor

Pete Stark

Joseph Biden

Jon Corzine

Richard Durbin

Russell Feingold

Peter Fitzgerald

Herb Kohl

Bill Nelson

Mark Pryor

John Dingell

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*April 29, 2004*

# Accounting Issues: 576 Companies Have Voluntarily Adopted Option Expensing Under the Fair Value Method

**Key Points**

*** We have identified 576 companies that have volunarily begun expensing stock options under the fair value method. These companies are listed in Appendix A.

*** One hundred sixteen of these companies are in the S&P 500 and represent 41% of the index based on market capitalization (see Appendix B). Seven of these companies are in the NASDAQ 100 and represent 12% of the index based on market capitalization (see Appendix C).

*** Three hundred thirty of these companies have market capitalizations in excess of $1 billion. One hundred four of these companies have market capitalizations in excess of $10 billion.

*** Two hundred forty of these companies are from the financial sector.

On March 31, 2004, the Financial Accounting Standards Board (FASB) released its Exposure Draft of a proposed revision to SFAS No. 123, which, if approved, will require public companies following US GAAP to begin expensing employee stock options under the modified prospective method for fiscal years beginning after December 15, 2004. For December year-end companies, this means the standard will take effect January 1, 2005. Under the modified prospective method, companies will be required to expense all unvested share-based compensation awards granted, modified, or settled after December 15, 1994. However, companies will not restate results of previous years. To learn more about the proposed changes to SFAS No. 123 in the Exposure Draft, please see our March 30, 2004 First Call, *Accounting Issues: Expensing Employee Stock Options in 2005 Would Lower S&P 500 Earnings by Less than 3%.*

We have identified 576 companies that have voluntarily adopted the fair value method as of April 28, 2004 (see Appendix A for the list of the companies). One hundred sixteen of these companies are members of the S&P 500 and represent 41% of the index based on market capitalization. Seven of these companies are members of the NASDAQ 100 and represent 12% of the index based on market capitalization. In Appendix B, we identify the S&P 500 companies that have adopted the fair value method and provide the 2003 pro forma stock option expense for all members of the index (based on the index composition as of March 19, 2004). In Appendix C, we identify the NASDAQ 100 companies that have adopted the fair value method and provide the 2003 pro forma stock option expense for all members of the index (based on the index composition as of March 19, 2004).

The 576 early adopters listed in Appendix A are a fairly even distribution of large and small companies. Three hundred thirty of the 576 companies identified as voluntary adopters in Appendix A have market capitalizations in excess of $1 billion. One hundred four of the 576 companies identified in Appendix A have market capitalizations in excess of $10 billion.

A large concentration of the adopters are in the financial sector. Of the 576 companies, 240 (42%) are companies in the financial sector.

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The vast majority of early adopters have opted to use the prospective method to expense stock options. We have identified the method adopted by 546 of 576 companies. Of the 546 companies, 454 (83%) are using the prospective method, 54 (16%) are using the modified prospective method, and 38 (7%) are using the retroactive restatement method. In accordance with the Exposure Draft, companies that have adopted the prospective method will be required to change to the modified prospective method in the first fiscal year beginning after December 15, 2004.

Under the prospective method, the fair value method of expensing stock options is applied *only* to options granted in the year of adoption and subsequently (under FAS No. 148, this method is no longer allowed to be adopted for fiscal years beginning after December 15, 2003). For definitions of the prospective, modified prospective, or retroactive restatement methods see Exhibit 1. For a more detailed explanation of the implications of adopting under the prospective, modified prospective, or retroactive restatement methods, see our February 12, 2004 First Call, *Accounting Issues: Companies Continue to Voluntarily Adopt Expensing of Stock Options Using the Fair Value Method.*

**Exhibit 1. Alternative Transition Methods Permitted Until 2004**

| | |
|---|---|
| **Prospective method**: | The fair value method of expensing options is applied only to options granted in the year of adoption and subsequently. Entities are not permitted to use this method for fiscal years beginning after December 15, 2003. |
| **Modified prospective method**: | The fair value method of expensing options is applied to all unvested options and options granted in the year of adoption and subsequently. |
| **Retroactive restatement method**: | The fair value method of expensing options is applied to all years presented as if it had been adopted for option grants after December 15, 1994. |

Source: Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of FASB Statement No. 123.*

For a detailed explanation of the accounting for stock-based compensation under FAS No. 123 and expected emerging changes in stock-based compensation granting trends, see our July 2003 Accounting Issues, *Accounting for Stock-Based Compensation: Restricted Stock and Employee Stock Options Compared.*

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method**

BEAR STEARNS

**Accounting and Taxation Research**
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Dane Mott (212) 272-4080

**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| SUA | Abbey National PLC | Dec-03 | No | 10,874 | 2002 | 3/7/2003 | Finance | Investment Management | Retroactive Restatement |
| ABER | Aber Diamond Corp | Jan-04 | No | 1,679 | 2003 | 12/3/2002 | Non-Energy Minerals | Other Metals/Minerals | Method Not Specified |
| AKR | Acadia Rlty Trust | Dec-03 | No | 346 | 2002 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| AES | AES Corp | Dec-03 | Yes | 4,948 | 2003 | 3/26/2003 | Utilities | Electric Utilities | Prospective |
| AEM | Agnico-Eagle Mines Limited | Dec-03 | No | 1,056 | 2003 | 5/7/2003 | Non-Energy Minerals | Precious Metals | Prospective |
| AGU | Agrium Inc | Dec-03 | No | 1,602 | 2003 | 02/12/2004 | Process Industries | Chemicals: Agricultural | Prospective |
| ACNAF | Air Canada | Dec-03 | No | 5,398 | 2002 | 2/12/2003 | Transportation | Airlines | Prospective |
| ALAB | Alabama National Bancorporation | Dec-03 | No | 798 | 1998 | 1998 | Finance | Regional Banks | Prospective (b) |
| AIN | Albany International Corp | Dec-03 | No | 990 | 2003 | 9/8/2003 | Process Industries | Textiles | Prospective |
| ARE | Alexandria Real Estate Equity Inc | Dec-03 | No | 1,106 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| Y | Alleghany Corp | Dec-03 | No | 2,027 | 2003 | 3/29/2003 | Finance | Property/Casualty Insurance | Prospective |
| AACB | Alliance Atlantis Communications, Inc | Mar-04 | No | 785 | 2003 | 8/7/2003 | Consumer Services | Broadcasting | Prospective |
| AC | Alliance Capital Management Holdings LP | Dec-03 | No | 8,841 | 2003 | 5/14/2003 | Finance | Investment Managers | Prospective |
| AZ | Allianz AG | Dec-03 | No | 40,061 | 2003 | 11/28/2003 | Finance | Multi-Line Insurance | Retroactive Restatement |
| ALL | Allstate Corp | Dec-03 | Yes | 32,772 | 2003 | 8/12/2002 | Finance | Property/Casualty Insurance | Prospective |
| AMZN | Amazon (c) | Dec-03 | No | 18,742 | N/A | 7/23/2002 | Retail Trade | Internet Retail | Not Adopted |
| AMB | AMB Property Corp | Dec-03 | No | 2,562 | 2002 | 7/8/2002 | Finance | Real Estate Investment Trusts | Prospective |
| ABK | Amlbac Financial Group Inc | Dec-03 | Yes | 7,896 | 2003 | 10/17/2002 | Finance | Specialty Insurance | Prospective |
| ACO | AMCOL International Corp | Dec-03 | No | 568 | 2003 | 5/14/2003 | Non-Energy Minerals | Construction Materials | Prospective |
| AEE | Ameren Corp | Dec-03 | Yes | 7,922 | 2003 | 3/5/2003 | Utilities | Electric Utilities | Prospective |
| ACAS | American Capital Strategies | Dec-03 | No | 1,840 | 2003 | 5/14/2003 | Finance | Finance/Rental/Leasing | Prospective |
| AXP | American Express | Dec-03 | Yes | 64,852 | 2003 | 8/12/2002 | Finance | Financial Conglomerates | Prospective |
| SCFN | American Independence Corp | Sep-03 | No | 131 | 2003 | 11/2/002 | Finance | Life/Health Insurance | Prospective |
| AIG | American International Group | Dec-03 | Yes | 192,913 | 2003 | 8/11/2002 | Finance | Multi-Line Insurance | Prospective |
| ANL | American Land Lease Inc | Dec-03 | No | 138 | 2003 | 3/26/2003 | Finance | Real Estate Investment Trusts | Prospective |
| AMK | American Technical Ceramic | Jun-04 | No | 72 | 2003 | 9/26/2003 | Electronic Technology | Electronic Components | Prospective |
| ACF | Americredit Corp | Jun-04 | No | 2,828 | 2003 | 11/10/2003 | Finance | Finance/Rental/Leasing | Prospective |
| AMTD | Ameritrade Holding Corp | Sep-03 | No | 5,867 | 2003 | 10/31/2003 | Finance | Investment Banks/Brokers | Prospective |
| APC | Anadarko Petroleum Corp | Dec-03 | Yes | 13,718 | 2003 | 3/14/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| AGCC | Anchor Glass Container Corp. | Dec-03 | No | 380 | 2003 | 5/15/2003 | Process Industries | Containers/Packaging | Prospective |
| ANR | Annuity And Life RE Holdings | Dec-03 | No | 30 | 2003 | 11/14/2003 | Finance | Life/Health Insurance | Prospective |
| APA | Apache Corp. | Dec-03 | Yes | 13,957 | 2003 | 03/12/2004 | Energy Minerals | Oil & Gas Production | Prospective |
| AIV | Apartment Investment & Management Co. | Dec-03 | Yes | 2,688 | 2003 | 3/7/2003 | Finance | Real Estate Investment Trusts | Prospective |
| AIT | Applied Industrial Technologies Inc | Jun-04 | No | 508 | 2003 | 10/14/2003 | Distribution Services | Wholesale Distributors | Modified Prospective |
| ARCH | Arch Wireless Inc | Dec-03 | No | N/A | 2003 | 8/12/2003 | Communications | Wireless Telecommunications | Prospective |
| ASN | Archstone Smith Trust | Dec-03 | No | 5,249 | 2003 | 3/3/2003 | Finance | Real Estate Investment Trusts | Prospective |
| ARI | Arden Realty Group | Dec-03 | No | 1,850 | 2003 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| ARTL | Ariatide Corp | Dec-03 | No | 52 | 2002 | 11/7/2002 | Consumer Non-Durables | Apparel/Footwear | Prospective |
| HOST | Arlington Hospitality Inc | Dec-03 | No | 17 | 2003 | 11/14/2003 | Consumer Services | Hotels/Resorts/Cruiselines | Method Not Specified |
| ARM | ArvinMeritor, Inc | Sep-03 | No | 1,477 | 2003 | 2/12/2003 | Producer Manufacturing | Auto Parts: OEM | Modified Prospective |
| ASH | Ashland Inc | Sep-03 | Yes | 3,344 | 2003 | 2/13/2003 | Energy Minerals | Oil Refining/Marketing | Modified Prospective |
| APGCF | Asia Pacific Resources Ltd | Feb-04 | No | 40,061 | 2003 | 7/1/2003 | Non-Energy Minerals | Other Metals/Minerals | Prospective |
| ALF | Assisted Living Concepts Inc | Dec-03 | No | 16 | 2003 | 8/14/2003 | Health Services | Hospital/Nursing Management | Prospective |
| ASUR | Assure Energy Inc. | Dec-03 | No | 5,398 | 2003 | 04/08/2004 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| T | AT&T | Dec-03 | Yes | 14,563 | 2003 | 10/22/2002 | Communications | Major Telecommunications | Prospective |
| ALRE | Atlas Resources International Inc | Mar-04 | No | 1 | 2003 | 11/14/2003 | Process Industries | Agricultural Commodities/Milling | Prospective |
| AROG | Aurora Gold Corp. | Dec-03 | No | 5 | 2003 | 03/25/2004 | Non-Energy Minerals | Precious Metals | Method Not Specified |
| AVB | Avalon Bay Communities Inc | Dec-03 | No | 3,575 | 2003 | 5/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| AVI | Avis Group Hldgs Inc (d) | Dec-03 | No | N/A | 2003 | 3/6/2003 | Finance | Finance/Rental/Leasing | Prospective |
| SMKE | Aviion Power | Dec-03 | No | - | 2003 | 3/15/2004 | Consumer Durables | Electronics/Appliances | Prospective |
| AXS | Axis Capital Holdings Limited | Dec-03 | No | 4,593 | 2003 | 02/11/2004 | Finance | Multi-Line Insurance | Prospective |
| BKR | Baker Michael Corp | Dec-03 | No | 106 | 2003 | 3/28/2003 | Industrial Services | Engineering & Construction | Prospective |
| BDG | Bandag Inc | Dec-03 | No | 934 | 2002 | 11/14/2002 | Consumer Durables | Automotive Aftermarket | Modified Prospective |
| BAC | Bank of America Corp | Dec-03 | Yes | 166,410 | 2003 | 8/12/2002 | Finance | Major Banks | Prospective |
| BK | Bank of New York Co. Inc | Dec-03 | Yes | 23,504 | 2003 | 8/13/2002 | Finance | Major Banks | Prospective |
| BNS | Bank of Nova Scotia | Oct-03 | No | 26,701 | 2003 | 12/4/2002 | Finance | Major Banks | Prospective |
| OZRK | Bank of the Ozarks Inc | Dec-03 | No | 401 | 2003 | 7/11/2003 | Finance | Regional Banks | Prospective |
| ONE | Bank One | Dec-03 | Yes | 56,561 | 2002 | 7/16/2002 | Finance | Major Banks | Prospective |
| BBUS | Barnabus Enterprises Ltd. | May-04 | No | - | 2003 | 10/31/2003 | Non-Energy Minerals | Precious Metals | Method Not Specified |
| MWH | BayCorp Holdings Corp | Dec-03 | No | 8 | 2003 | 8/14/2002 | Utilities | Electric Utilities | Prospective |
| BCE | BCE Inc | Dec-03 | No | 18,901 | 2003 | 12/18/2002 | Communications | Major Telecommunications | Prospective |
| BSC | Bear Stearns Cos Inc | Nov-03 | Yes | 8,655 | 2003 | 2/26/2003 | Finance | Investment Banks/Brokers | Prospective |
| BED | Bedford Property Investors Inc | Dec-03 | No | 459 | 2003 | 3/11/2003 | Finance | Real Estate Investment Trusts | Modified Prospective |
| BLS | BellSouth Corp | Dec-03 | Yes | 49,199 | 2003 | 2/28/2003 | Communications | Major Telecommunications | Retroactive Restatement |
| BMRB | Bendmark Bankshares Inc | Dec-03 | No | 45 | 2003 | 03/22/2004 | Finance | Regional Banks | Prospective |
| BETA | Beta Oil & Gas Inc | Dec-03 | No | 40 | 2003 | 3/31/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| AQCB | Bevsystems International Inc. | Mar-04 | No | N/A | 2003 | 9/10/2003 | Consumer Non-Durables | Beverages: Non-Alcoholic | Method Not Specified |
| BBL | BHP Billiton PLC | Jun-04 | No | 52,659 | 2003 | 10/23/2003 | Non-Energy Minerals | Other Metals/Minerals | Modified Prospective |
| BICR | Biocerai Inc | Dec-03 | No | 40,051 | 2003 | 3/13/2003 | Health Technology | Medical Specialties | Prospective |
| BLK | Blackrock Inc | Dec-03 | No | 3,697 | 2003 | 5/15/2003 | Finance | Investment Managers | Prospective |
| BA | Boeing Co | Dec-03 | Yes | 35,785 | 1998 | 1998 | Electronic Technology | Aerospace & Defense | Prospective (b) |
| BCC | Boise Cascade Corp. | Dec-03 | Yes | 3,170 | 2003 | 03/02/2004 | Process Industries | Pulp & Paper | Prospective |
| BOKF | BOK Financial Corp. | Dec-03 | No | 2,349 | 2003 | 11/14/2003 | Finance | Regional Banks | Retroactive Restatement |
| BSHI | Boss Holdings Inc | Dec-03 | No | 14 | 2003 | 3/28/2003 | Consumer Non-Durables | Apparel/Footwear | Prospecave |
| BDN | Brandywine Realty Trust | Dec-03 | No | 1,181 | 2002 | 3/27/2003 | Finance | Real Estate Investment Trusts | Prospective |
| BNN | Brascan Corp. | Dec-03 | No | 6,014 | 2002 | 05/21/2003 | Finance | Financial Conglomerates | Prospective |
| BRE | BRE Properties, Inc | Dec-03 | No | 1,577 | 2003 | 10/14/2002 | Finance | Real Estate Investment Trusts | Prospective |
| CGT | CAE Inc | Mar-04 | No | 938 | 2003 | 8/8/2003 | Electronic Technology | Aerospace & Defense | Method Not Specified |
| CALC | California Coastal Communities, Inc | Dec-03 | No | -156 | 2003 | 9/17/2003 | Finance | Real Estate/Development | Modified Prospective |

Bear Stearns does and seeks to do business with companies covered in its research reports. As a result investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Please refer to the last page of this report for important disclosure and certification information

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| CLPO | Calprop Corp | Dec-03 | No | 3 | 2002 | 4/25/2003 | Consumer Durables | Homebuilding | Prospective |
| CAC | Camden National Corp | Dec-03 | No | 245 | 2003 | 8/27/2002 | Finance | Regional Banks | Prospective |
| CCJ | Cameco Corp | Dec-03 | No | 2,600 | 2003 | 1/28/2004 | Non-Energy Minerals | Other Metals/Minerals | Prospective |
| CLU | Canada Life Financial Corp (e) | Dec-03 | No | 39 | 2003 | 12/9/2002 | Finance | Life/Health Insurance | Prospective |
| CNI | Canadian National Railway Company | Dec-03 | No | 11,475 | 2003 | 4/23/2003 | Transportation | Railroads | Prospective |
| COS.UN | Canadian Oil Sands Trust | Dec-03 | No | N/A | 2003 | 10/23/2003 | Miscellaneous | Investment Trusts/Mutual Funds | Method Not Specified |
| CP | Canadian Pacific Railway Limited | Dec-03 | No | 3,730 | 2003 | 1/27/2004 | Transportation | Railroads | Prospective |
| GUSH | Canargo Energy Corp | Dec-03 | No | 96 | 2003 | 11/14/2003 | Industrial Services | Oilfield Services/Equipment | Prospective |
| CCBG | Capital City Bank Group Inc | Dec-03 | No | 556 | 2003 | 5/15/2003 | Finance | Regional Banks | Prospective |
| CTDN | Capital Directions Inc | Dec-03 | No | 32 | 2002 | 3/31/2003 | Finance | Major Banks | Prospective |
| COF | Capital One Financial Corp | Dec-03 | Yes | 16,449 | 2003 | 1/21/2004 | Finance | Finance/Rental/Leasing | Prospective |
| RKE | Capital Rock Energy Corp. | Dec-03 | No | 51 | 2003 | 8/19/2003 | Utilities | Electric Utilities | Retroactive Restatement |
| CSWC | Capital Southwest Corp | Mar-04 | No | 305 | 2003 | 8/8/2003 | Finance | Miscellaneous | Prospective |
| CORRF | CardiOne Pharma Corp. | Dec-03 | No | 185 | 2003 | 04/20/2004 | Health Technology | Biotechnology | Prospective |
| CRE | Carramerica Realty Corp | Dec-03 | No | 1,569 | 2003 | 2/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| CATY | Cathay Bancorp, Inc (f) | Dec-03 | No | 1,646 | 2003 | 4/15/2003 | Finance | Regional Banks | Method Not Specified |
| CBL | CBL & Associates Properties, Inc | Dec-03 | No | 1,561 | 2003 | 10/29/2002 | Finance | Real Estate Investment Trusts | Prospective |
| | CBRE Holdings Inc. (g) | Dec-03 | No | N/A | 2002 | 4/30/2003 | Finance | Real Estate Investment Trusts | Prospective |
| GLDUE | CDG Investments Inc. | Sep-03 | No | 3 | 2003 | 2/28/2003 | Non-Energy Minerals | Precious Metals | Prospective |
| CFK | CE Franklin Limited | Dec-03 | No | 61 | 2003 | 04/12/2004 | Industrial Services | Oilfield Services/Equipment | Prospective |
| FUN | Cedar Fair, L.P. | Dec-03 | No | 1,621 | 2003 | 5/8/2003 | Consumer Services | Movies/Entertainment | Modified Prospective |
| CZ | Celanese AG | Dec-03 | No | 2,009 | 2002 | 10/22/2002 | Process Industries | Chemicals: Specialty | Method Not Specified |
| CLS | Celestica Inc | Dec-03 | No | 4,149 | 2003 | 1/29/2004 | Electronic Technology | Electronic Components | Prospective |
| CD | Cendant Corp (d) | Dec-03 | Yes | 25,159 | 2003 | 9/26/2002 | Consumer Services | Other Consumer Services | Prospective |
| CTX | Centex Corp | Mar-04 | Yes | 6,839 | 2004 | 9/12/2002 | Consumer Durables | Homebuilding | Prospective |
| CETVF | Central European Media Enterprise | Dec-03 | No | 2,069 | 2003 | 5/7/2003 | Consumer Services | Broadcasting | Prospective |
| CHG | CH Energy Group Inc | Dec-03 | No | 751 | 2003 | 2/19/2003 | Utilities | Electric Utilities | Modified Prospective |
| CPLY | Championlyte Holdings Inc | Dec-03 | No | 6 | 2002 | 8/19/2003 | Consumer Non-Durables | Food: Specialty/Candy | Prospective |
| CHTR | Charter Communications | Dec-03 | No | 1,334 | 2002 | 8/6/2002 | Consumer Services | Cable/Satellite TV | Prospective |
| CME | Chicago Mercantile Exchange Holdings Inc | Dec-03 | No | 3,921 | 2003 | 1/10/2003 | Finance | Investment Banks/Brokers | Retroactive Restatement |
| CEVC | China Energy Ventures Corp | Dec-03 | No | 22 | 2002 | 4/16/2003 | Communications | Specialty Telecommunications | Prospective |
| CHH | Choice Hotels International, Inc | Dec-03 | No | 1,591 | 2003 | 9/25/2002 | Consumer Services | Hotels/Resorts/Cruselines | Prospective |
| CWON | Choice One Communications | Dec-03 | No | 23 | 2003 | 11/21/2002 | Communications | Specialty Telecommunications | Prospective |
| CB | Chubb Corp | Dec-03 | Yes | 13,079 | 2003 | 8/14/2002 | Finance | Property/Casualty Insurance | Modified Prospective |
| CSB | Ciba Specialty Chemicals Holdings Inc | Dec-03 | No | 4,552 | 2003 | 2/4/2003 | Process Industries | Chemicals: Specialty | Modified Prospective |
| CIN | Cinergy Corp | Dec-03 | Yes | 6,945 | 2003 | 7/24/2002 | Utilities | Electric Utilities | Prospective |
| C | Citigroup | Dec-03 | Yes | 254,265 | 2003 | 8/4/2002 | Finance | Financial Conglomerates | Prospective |
| CLF | Cleveland-Cliffs Inc | Dec-03 | No | 594 | 2003 | 4/24/2003 | Non-Energy Minerals | Steel | Prospective |
| CMS | CMS Energy Corp | Dec-03 | Yes | 1,426 | 2003 | 3/31/2003 | Utilities | Electric Utilities | Prospective |
| KO | Coca-Cola Co. | Dec-03 | Yes | 124,219 | 2002 | 7/14/2002 | Consumer Non-Durables | Beverages: Non-Alcoholic | Modified Prospective |
| COHT | Cohesant Technologies Inc | Nov-03 | No | 18 | 2003 | 3/31/2003 | Producer Manufacturing | Industrial Machinery | Modified Prospective |
| CLP | Colonial Properties Trust | Dec-03 | No | 982 | 2003 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| CMA | Comerica | Dec-03 | Yes | 9,105 | 2002 | 8/6/2002 | Finance | Major Banks | Prospective |
| CMMD | Command Securities | Mar-04 | No | 8 | 2002 | 6/30/2003 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| CBSH | Commerce Bancshares, Inc | Dec-03 | No | 3,027 | 2003 | 2/3/2003 | Finance | Regional Banks | Retroactive Restatement |
| NNN | Commercial Net Lease Realty | Dec-03 | No | 875 | 2003 | 03/12/2004 | Finance | Real Estate Investment Trusts | Prospective |
| CA | Computer Associates | Mar-04 | Yes | 16,540 | 2003 | 7/29/2002 | Technology Services | Packaged Software | Prospective |
| COP | ConocoPhillips | Dec-03 | Yes | 51,071 | 2003 | 9/25/2002 | Energy Minerals | Integrated Oil | Prospective |
| MCF | Contango Oil & Gas | Jun-04 | No | 91 | 2002 | 8/5/2002 | Energy Minerals | Oil & Gas Production | Prospective |
| CBE | Cooper Industries | Dec-03 | Yes | 5,398 | 2003 | 9/5/2002 | Producer Manufacturing | Electrical Products | Prospective |
| CORS | Corus Bankshares Inc | Dec-03 | No | 1,074 | 2003 | 1/20/2004 | Finance | Regional Banks | Modified Prospective |
| COST | Costco Wholesale Corp | Aug-03 | Yes | 262 | 2003 | 8/14/2002 | Retail Trade | Discount Stores | Prospective |
| TEU | CP Ships Limited | Dec-03 | No | 1,550 | 2004 | 04/07/2004 | Transportation | Marine Shipping | Modified Prospective |
| CACC | Credit Acceptance Michigan | Dec-03 | No | 641 | 2003 | 4/24/2003 | Finance | Finance/Rental/Leasing | Retroactive Restatement |
| CSR | Credit Suisse Group | Dec-03 | No | 38,711 | 2003 | 8/5/2003 | Finance | Major Banks | Prospective |
| CREO | Creo Inc. | Sep-03 | No | 433 | 2004 | 2/12/2004 | Technology Services | Packaged Software | Method Not Specified |
| CEI | Crescent Real Estate Equities Co. | Dec-03 | No | 1,574 | 2003 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| CWN | Crown American Realty | Dec-03 | No | N/A | 2003 | 8/13/2003 | Finance | Real Estate Investment Trusts | Modified Prospective |
| CCI | Crown Castle International Inc | Dec-03 | No | 3,391 | 2003 | 5/13/2003 | Communications | Specialty Telecommunications | Prospective |
| CSGS | CSG Systems International | Dec-03 | No | 884 | 2003 | 12/10/2003 | Technology Services | Data Processing Services | Prospective |
| CSX | CSX Corp | Dec-03 | Yes | 6,731 | 2003 | 2/26/2003 | Transportation | Railroads | Prospective |
| CMI | Cummins Inc | Dec-03 | Yes | 2,697 | 2003 | 5/12/2003 | Producer Manufacturing | Trucks/Construction/Farm Machinery | Prospective |
| DCX | DaimlerChrysler AG - ADR | Dec-03 | No | 45,857 | 2003 | 7/24/2003 | Consumer Durables | Motor Vehicles | Prospective |
| DTMG | DataMEG Corp | Dec-03 | No | 25 | 2003 | 4/16/2003 | Electronic Technology | Electronic Components | Prospective |
| DLM | Del Monte Foods Company | Apr-04 | No | 2,421 | 2003 | 7/22/2003 | Consumer Non-Durables | Food: Major Diversified | Prospective |
| DFG | Delphi Financial Group, Inc | Dec-03 | No | 1,271 | 2003 | 7/23/2003 | Finance | Life/Health Insurance | Prospective |
| DLX | Deluxe Corp. | Dec-03 | Yes | 2,070 | 2004 | 03/12/2004 | Commercial Services | Commercial Printing/Forms | Modified Prospective |
| DB | Deutsche Bank AG | Dec-03 | No | 47,968 | 2003 | 3/27/2003 | Finance | Major Banks | Prospective |
| DTPI | Diamondcluster International | Mar-04 | No | 358 | 2003 | 8/13/2003 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| DVS | Diversified Security Solutions Inc | Dec-03 | No | 38 | 2003 | 5/15/2003 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| NSKY | Document Security Systems Inc | Dec-03 | No | 1,018 | 2003 | 11/14/2003 | Commercial Services | Commercial Printing/Forms | Prospective |
| DOL | Dole Foods (h) | Dec-03 | No | N/A | 2003 | 7/15/2002 | Consumer Non-Durables | Food: Major Diversified | Prospective |
| DTG | Dollar Thrifty Automotive Group Inc | Dec-03 | No | 693 | 2003 | 5/14/2003 | Finance | Finance/Rental/Leasing | Prospective |
| DTC | Domtar Inc | Dec-03 | No | 2,797 | 2002 | 04/01/2004 | Process Industries | Pulp & Paper | Prospective |
| DRL | Doral Financial Corp | Dec-03 | No | 3,507 | 2003 | 2/4/2003 | Finance | Finance/Rental/Leasing | Modified Prospective |
| DOW | Dow Chemical Company | Dec-03 | Yes | 38,741 | 2003 | 9/26/2002 | Process Industries | Chemicals: Major Diversified | Prospective |
| DPL | DPL Inc | Dec-03 | No | 2,328 | 2003 | 2/20/2003 | Utilities | Electric Utilities | Prospective |
| DW | Draw Industries Inc | Dec-03 | No | 378 | 2002 | 3/26/2003 | Producer Manufacturing | Building Products | Prospective |
| DRE | Duke Realty | Dec-03 | No | 4,064 | 2002 | 7/31/2002 | Finance | Real Estate Investment Trusts | Prospective |
| DD | DuPont | Dec-03 | Yes | 44,423 | 2003 | 11/5/2002 | Process Industries | Chemicals: Major Diversified | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| DDN | Dynamex Inc | Jul-03 | No | 156 | 2004 | 6/16/2003 | Transportation | Air Freight/Couriers | Modified Prospective |
| DYN | Dynegy Inc | Dec-03 | Yes | 1,431 | 2003 | 4/11/2003 | Utilities | Gas Distributors | Prospective |
| EACE | eAccelaration Corp | Dec-03 | No | 5,398 | 2003 | 11/12/2003 | Technology Services | Packaged Software | Modified Prospective |
| ERMC | Eagle River Mining Corp. | Dec-03 | No | - | N/A | 04/09/2004 | Non-Energy Minerals | Precious Metals | Method Not Specified |
| EGP | Eastgroup Properties Inc | Dec-03 | No | 623 | 2002 | 03/15/2004 | Finance | Real Estate Investment Trusts | Prospective |
| ECLG | Ecollege.com Inc | Dec-03 | No | 424 | 2003 | 1/21/2004 | Technology Services | Internet Software/Services | Prospective |
| EGAM | EGames Inc | Jun-04 | No | 17 | 2003 | 11/14/2002 | Consumer Durables | Recreational Products | Prospective |
| EGO | Eldorado Gold Corp. | Dec-03 | No | 655 | 2003 | 03/09/2004 | Non-Energy Minerals | Precious Metals | Prospective |
| ELI | Elite Pharmaceuticals Inc | Mar-04 | No | 48 | 2003 | 2/14/2003 | Health Technology | Pharmaceuticals: Generic | Prospective |
| ISEE | Emerging Vision Inc | Dec-03 | No | 9 | 2003 | 04/05/2004 | Retail Trade | Specialty Stores | Prospective |
| EMR | Emerson Electronics | Sep-03 | Yes | 26,179 | 2003 | 8/6/2002 | Producer Manufacturing | Electrical Products | Prospective |
| NYNY | Empire Resorts Inc | Dec-03 | No | 373 | 2003 | 5/15/2003 | Consumer Services | Casinos/Gaming | Prospective |
| ENH | Endurance Specialty Holdings Limited | Dec-03 | No | 2,164 | 2002 | 1/28/2003 | Finance | Property/Casualty Insurance | Prospective |
| EGN | Energen | Dec-03 | No | 1,501 | 2003 | 03/12/2004 | Utilities | Gas Distributors | Prospective |
| EBF | Ennis Business Forms Inc | Feb-04 | No | 261 | 2003 | 6/27/2003 | Commercial Services | Commercial Printing/Forms | Prospective |
| ETR | Entergy Corp | Dec-03 | Yes | 13,028 | 2003 | 3/19/2003 | Utilities | Electric Utilities | Prospective |
| ETOP | Entropin Inc | Dec-03 | No | 7 | 1999 | 1999 | Health Technology | Pharmaceuticals: Other | Prospective (b) |
| ENT | Equant NV (v) | Dec-03 | No | 2,595 | 2002 | 3/17/2003 | Technology Services | Information Technology Services | Modified Prospective |
| EOP | Equity Office Properties | Dec-03 | Yes | 10,226 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| EQR | Equity Residential | Dec-03 | Yes | 7,653 | 2003 | 5/13/2003 | Finance | Real Estate Investment Trusts | Prospective |
| ESS | Essex Property Trust Inc | Dec-03 | No | 1,398 | 2004 | 03/15/2004 | Finance | Real Estate Investment Trusts | Retroactive Restatement |
| RE | Everest Re Group, Ltd | Dec-03 | No | 4,720 | 2002 | 10/21/2002 | Finance | Property/Casualty Insurance | Prospective |
| EXFO | Exfo Electro Optical Engineering Inc | Aug-03 | No | 316 | 2004 | 03/31/2004 | Electronic Technology | Electronic Equipment/Instruments | Prospective |
| EXPE | Expedia, Inc (i) | Dec-03 | No | N/A | 2003 | 2/5/2003 | Consumer Services | Other Consumer Services | Prospective |
| XOM | Exxon Mobil Corp (j) | Dec-03 | Yes | 281,777 | 2003 | 3/26/2003 | Energy Minerals | Integrated Oil | Prospective |
| FNM | Fannie Mae | Dec-03 | Yes | 67,838 | 2003 | 7/23/2002 | Finance | Finance/Rental/Leasing | Prospective |
| FFG | FBL Financial Group, Inc | Dec-03 | No | 766 | 2003 | 8/29/2002 | Finance | Life/Health Insurance | Prospective |
| FII | Federated Investors Inc | Dec-03 | Yes | 3,238 | 2003 | 03/12/2004 | Finance | Investment Managers | Prospective |
| FCH | FelCor Lodging Trust Inc | Dec-03 | No | 801 | 2003 | 10/30/2002 | Finance | Real Estate Investment Trusts | Prospective |
| FNF | Fidelity National Financial Inc | Dec-03 | No | 6,159 | 2003 | 10/23/2003 | Finance | Specialty Insurance | Prospective |
| FITB | Fifth Third Bancorp | Dec-03 | Yes | 31,013 | 2004 | 04/14/2004 | Finance | Regional Banks | Retroactive Restatement |
| FCBP | First Community Bancorp | Dec-03 | No | 544 | 2003 | 1/17/2003 | Finance | Regional Banks | Prospective |
| FLLC | First Financial Bancorp California | Dec-03 | No | 30 | 2003 | 5/14/2003 | Finance | Major Banks | Prospective |
| FR | First Industrial Realty Trust, Inc | Dec-03 | No | 1,429 | 2003 | 2/12/2003 | Finance | Real Estate Investment Trusts | Prospective |
| FKYS | First Keystone Corp | Dec-03 | No | 112 | 2003 | 5/13/2003 | Finance | Major Banks | Prospective |
| FNSC | First National Bancshares Inc | Dec-03 | No | 51 | 2003 | 03/30/2004 | Finance | Regional Banks | Prospective |
| FNCB | First National Community Bancorp, Inc | Dec-03 | No | 161 | 2003 | 5/9/2003 | Finance | Major Banks | Prospective |
| FNRN | First Northern Community Bancorp | Dec-03 | No | 94 | 2003 | 5/14/2003 | Finance | Regional Banks | Prospective |
| FRC | First Republic Bank | Dec-03 | No | 575 | 2003 | 6/23/2003 | Finance | Regional Banks | Prospective |
| FBF | FleetBoston Financial Corp | Dec-03 | Yes | N/A | 2002 | 8/14/2002 | Finance | Major Banks | Prospective |
| FLM | Fleming Companies Inc | Dec-03 | No | 0 | 2003 | 8/8/2002 | Distribution Services | Food Distributors | Method Not Specified |
| FTI | FMC Technologies Inc | Dec-03 | No | 1,867 | 2004 | 03/26/2004 | Industrial Services | Oilfield Services/Equipment | Retroactive Restatement |
| FNBG | FNB Bancorp | Dec-03 | No | 79 | 2003 | 3/31/2003 | Finance | Regional Banks | Prospective |
| FNX | FNX Mining Company Inc | Dec-03 | No | 226 | 2004 | 11/18/2003 | Non-Energy Minerals | Other Metals/Minerals | Retroactive Restatement |
| F | Ford Motor Company (k) | Dec-03 | Yes | 28,746 | 2003 | 9/12/2002 | Consumer Durables | Motor Vehicles | Modified Prospective |
| FDG | Fording Canadian Coal Trust | Dec-03 | No | 1,550 | 2003 | 2/4/2004 | Energy Minerals | Coal | Prospective |
| FS | Four Seasons Hotels Inc | Dec-03 | No | 1,945 | 2003 | 03/17/2004 | Consumer Services | Hotels/Resorts/Cruiselines | Prospective |
| WFA | France Telecommunications (v) | Dec-03 | No | 59,051 | 2002 | 3/21/2003 | Communications | Major Telecommunications | Modified Prospective |
| FRE | Freddie Mac | Dec-03 | Yes | 39,833 | 2002 | 7/23/2002 | Finance | Finance/Rental/Leasing | Retroactive Restatement |
| GBL | Gabelli Asset Management Inc | Dec-03 | No | 1,180 | 2003 | 7/26/2002 | Finance | Investment Managers | Prospective |
| GBP | Gables Residential | Dec-03 | No | 934 | 2003 | 11/4/2002 | Finance | Real Estate Investment Trusts | Prospective |
| GXY | Galaxy Nutritional Foods | Mar-04 | No | 31 | 2003 | 8/14/2003 | Consumer Non-Durables | Food: Meat/Fish/Dairy | Prospective |
| AJG | Gallagher (Arthur J) | Dec-03 | No | 2,933 | 2003 | 1/27/2004 | Finance | Insurance Brokers/Services | Prospective |
| GBCB | GBC Bancorp (f) | Dec-03 | No | N/A | 2003 | 7/16/2003 | Finance | Regional Banks | Method Not Specified |
| GE | General Electric | Dec-03 | Yes | 309,314 | 2002 | 7/31/2002 | Producer Manufacturing | Industrial Conglomerates | Prospective |
| JOB | General Employment Enterprises, Inc | Sep-03 | No | 9 | 2002 | 9/5/2002 | Commercial Services | Personnel Services | Method Not Specified |
| GM | General Motors | Dec-03 | Yes | 27,762 | 2003 | 8/6/2002 | Consumer Durables | Motor Vehicles | Prospective |
| GPC | Genuine Parts | Dec-03 | Yes | 6,399 | 2003 | 3/5/2003 | Distribution Services | Wholesale Distributors | Prospective |
| GP | Georgia Pacific Corp | Dec-03 | Yes | 9,695 | 2003 | 11/10/2003 | Process Industries | Pulp & Paper | Prospective |
| GTAX | Gilman & Ciocia | Jun-04 | No | 5 | 2002 | 1/21/2004 | Consumer Services | Other Consumer Services | Prospective |
| GS | Goldman Sachs Group Inc | Nov-03 | Yes | 48,456 | 2003 | 6/13/2002 | Finance | Investment Banks/Brokers | Prospective |
| GVA | Granite Construction Inc | Dec-03 | No | 938 | 2003 | 3/28/2003 | Industrial Services | Engineering & Construction | Prospective |
| GXP | Great Plains Energy | Dec-03 | No | 2,243 | 2003 | 11/14/2002 | Utilities | Electric Utilities | Modified Prospective |
| GREY | Grey Global Group Inc | Dec-03 | No | 1,018 | 2003 | 8/14/2002 | Commercial Services | Advertising/Marketing Services | Prospective |
| GNTY | Guaranty Bancshares, Inc | Dec-03 | No | 58 | 2002 | 9/6/2002 | Finance | Regional Banks | Modified Prospective |
| GTRC | Guitar Center | Dec-03 | No | 892 | 2003 | 6/13/2003 | Retail Trade | Specialty Stores | Prospective |
| HRB | H&R Block Inc (l) | Apr-04 | Yes | 8,241 | 2004 | 9/11/2002 | Consumer Services | Other Consumer Services | Prospective |
| | Haights Cross Communications, Inc. | Dec-03 | No | N/A | 2002 | 10/2/2003 | Consumer Services | Publishing: Educational and Professional | Prospective |
| HAF | Hallmark Financial Services Inc | Dec-03 | No | 22 | 2003 | 5/15/2003 | Finance | Property/Casualty Insurance | Prospective |
| HANA | Hanaro Telecom Inc | Dec-03 | No | 744 | 2003 | 6/6/2003 | Communications | Major Telecommunications | Modified Prospective |
| JHF | Hancock John Financial Services | Dec-03 | Yes | 13,545 | 2003 | 5/14/2003 | Finance | Financial Conglomerates | Prospective |
| HDL | Handleman Company | Apr-04 | No | 584 | 2003 | 9/10/2002 | Distribution Services | Wholesale Distributors | Prospective |
| JHX | Hardie James Industries NV | Mar-04 | No | 2,181 | 2003 | 5/28/2003 | Non-Energy Minerals | Construction Materials | Retroactive Restatement |
| HAR | Harman International Industries | Jun-04 | No | 5,646 | 2003 | 5/19/2002 | Consumer Durables | Electronics/Appliances | Prospective |
| HIG | Hartford Financial Services Group, Inc | Dec-03 | Yes | 18,588 | 2003 | 9/24/2002 | Finance | Multi-Line Insurance | Prospective |
| | Hartman Commercial Properties REIT | N/A | No | N/A | 2003 | 8/6/2003 | Finance | Real Estate Investment Trusts | Prospective |
| HNR | Harvest Natural Resources | Dec-03 | No | 560 | 2003 | 3/31/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| HE | Hawaiian Electric Industries Inc | Dec-03 | No | 1,914 | 2002 | 1/21/2003 | Utilities | Electric Utilities | Modified Prospective |
| HCP | Health Care Property Investors Inc | Dec-03 | No | 6,249 | 2002 | 2/20/2003 | Finance | Real Estate Investment Trusts | Prospective |
| HCN | Health Care REIT Inc | Dec-03 | No | 1,691 | 2003 | 5/1/2003 | Finance | Real Estate Investment Trusts | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| HETC | Healthetech Inc | Dec-03 | No | 14 | 2003 | 03/29/2004 | Health Technology | Medical Specialties | Prospective |
| HMSL | Hemosol Inc | Dec-03 | No | 42 | 2003 | 03/19/2004 | Health Technology | Biotechnology | Prospective |
| HPC | Hercules Inc | Dec-03 | Yes | 1,331 | 2003 | 8/7/2003 | Process Industries | Chemicals: Major Diversified | Prospective |
| HPG | Heritage Propane Partners | Aug-03 | No | N/A | 2003 | 11/26/2003 | Utilities | Gas Distributors | Modified Prospective |
| HIW | Highwoods Properties Inc | Dec-03 | No | 1,231 | 2003 | 3/22/2003 | Finance | Real Estate Investment Trusts | Prospective |
| SLMM | Hockey Company | Dec-03 | No | N/A | 2003 | 03/26/2004 | Consumer Durables | Recreational Products | Prospective |
| HD | Home Depot Inc | Jan-04 | Yes | 81,807 | 2003 | 8/23/2002 | Retail Trade | Home Improvement Chains | Prospective |
| HME | Home Properties of New York Inc | Dec-03 | No | 1,231 | 2003 | 8/7/2002 | Finance | Real Estate Investment Trusts | Modified Prospective |
| HRL | Hormel Foods Corp | Oct-03 | No | 4,297 | 2003 | 11/7/2003 | Consumer Non-Durables | Food: Meat/Fish/Dairy | Prospective |
| HMT | Host Marriott Corp | Dec-03 | No | 3,962 | 2002 | 10/16/2002 | Finance | Real Estate Investment Trusts | Prospective |
| HI | Household International Inc (m) | Dec-03 | No | N/A | 2002 | 8/12/2002 | Finance | Finance/Rental/Leasing | Prospective |
| THX | Houston Exploration Company | Dec-03 | No | 1,437 | 2003 | 2/21/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| HBC | HSBC Holdings PLC (m) | Dec-03 | No | 162,445 | 2002 | 2/20/2003 | Finance | Major Banks | Prospective |
| HU | Hudson United Bancorp | Dec-03 | No | 1,638 | 2003 | 3/14/2003 | Finance | Regional Banks | Prospective |
| HUVL | Hudson Valley Holding | Dec-03 | No | N/A | 2002 | 3/27/2003 | Finance | Regional Banks | Prospective |
| HS | Hughes Electronics Corp | Dec-03 | No | 24,960 | 2003 | 5/8/2003 | Consumer Services | Cable/Satellite TV | Prospective |
| HBEK | Humboldt Bancorp | Dec-03 | No | 294 | 2003 | 3/28/2003 | Finance | Major Banks | Prospective |
| HYPD | Hypertynamics | Jun-04 | No | 89 | 2004 | 02/23/2004 | Technology Services | Information Technology Services | Retroactive Restatement |
| IRW | IBT Bancorp Inc | Dec-03 | No | 137 | 2003 | 03/15/2004 | Finance | Regional Banks | Prospective |
| ICOC | ICO Inc | Sep-03 | No | 49 | 2003 | 2/14/2003 | Industrial Services | Oilfield Services/Equipment | Prospective |
| N | Inco Limited | Dec-03 | No | 6,132 | 2003 | 2/4/2003 | Non-Energy Minerals | Other Metals/Minerals | Prospective |
| IMKTA | Ingles Markets Inc | Sep-03 | No | 268 | 2003 | 12/22/2003 | Retail Trade | Food Retail | Prospective |
| IFS | Insignia Financial Group, Inc (g) | Dec-03 | No | N/A | 2002 | 7/24/2002 | Finance | Real Estate Development | Prospective |
| INMD | Integramed America Inc | Dec-03 | No | 28 | 2003 | 11/13/2003 | Health Services | Medical/Nursing Services | Prospective |
| USAI | Interactive Corp (j) | Dec-03 | No | 5,398 | 2003 | 7/24/2002 | Retail Trade | Internet Retail | Prospective |
| ITGB | International Thoroughbreds Breeders | Jun-04 | No | 13 | 2003 | 10/14/2003 | Consumer Services | Casinos/Gaming | Prospective |
| ICCSA | Internet Commerce Corp. | Jul-03 | No | 5,398 | 2004 | 03/18/2004 | Technology Services | Internet Software/Services | Prospective |
| MNR | Interstate Hotels & Resorts, Inc | Dec-03 | No | 1,018 | 2003 | 5/12/2003 | Consumer Services | Hotels/Resorts/Cruiselines | Prospective |
| IAIA | Intier Automotive Inc | Dec-03 | No | 810 | 2003 | 02/24/2004 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| ITG | Investment Technology Group New | Dec-03 | No | 655 | 2003 | 03/12/2004 | Finance | Investment Banks/Brokers | Prospective |
| INVS | INVESTools Inc | Dec-03 | No | 93 | 2003 | 3/21/2003 | Finance | Savings Banks | Prospective |
| IOM | Iomega | Dec-03 | No | 279 | 2003 | 7/24/2002 | Electronic Technology | Computer Peripherals | Prospective |
| IPCR | IPC Holdings, Ltd | Dec-03 | No | 1,693 | 2003 | 3/18/2003 | Finance | Property/Casualty Insurance | Prospective |
| IPS | Ipsco Inc | Dec-03 | No | 927 | 2003 | 04/02/2004 | Non-Energy Minerals | Steel | Prospective |
| IRM | Iron Mountain Inc | Dec-03 | No | 3,781 | 2003 | 3/21/2003 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| IST | Ispat International NV | Dec-03 | No | 1,334 | 2003 | 03/10/2004 | Non-Energy Minerals | Steel | Prospective |
| SFI | iStar Financial | Dec-03 | No | 4,163 | 2003 | 7/24/2002 | Finance | Real Estate Investment Trusts | Prospective |
| HUGO | Ivanhoe Mines Limited | Dec-03 | No | 1,600 | 2002 | 11/17/2003 | Non-Energy Minerals | Other Metals/Minerals | Modified Prospective |
| JPM | J.P. Morgan Chase & Co. | Dec-03 | Yes | 79,729 | 2003 | 8/12/2002 | Finance | Financial Conglomerates | Prospective |
| JEF | Jefferies Group, Inc | Dec-03 | No | 2,061 | 2003 | 2/5/2003 | Finance | Investment Banks/Brokers | Prospective |
| JASA | Jo-Ann Stores Inc | Jan-04 | No | 5,398 | 2003 | 5/29/2003 | Retail Trade | Specialty Stores | Modified Prospective |
| JCI | Johnson Controls Inc | Sep-03 | Yes | 11,062 | 2003 | 10/9/2002 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| JNY | Jones Apparel Group Inc | Dec-03 | Yes | 4,773 | 2003 | 7/31/2002 | Consumer Non-Durables | Apparel/Footwear | Prospective |
| KWD | Kellwood Co. (w) | Jan-04 | No | 1,117 | 2003 | 8/28/2002 | Consumer Non-Durables | Apparel/Footwear | Not Adopted |
| KEY | KeyCorp | Dec-03 | Yes | 12,422 | 2003 | 10/17/2002 | Finance | Major Banks | Prospective |
| KSE | Keyspan Corp | Dec-03 | Yes | 5,808 | 2003 | 9/26/2002 | Utilities | Gas Distributors | Prospective |
| KTR | Keystone Property Trust | Dec-03 | No | 638 | 2003 | 4/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| KRC | Kilroy Realty Corp | Dec-03 | No | 912 | 2002 | 8/13/2002 | Finance | Real Estate Investment Trusts | Prospective |
| KIM | Kimco Realty Corp | Dec-03 | No | 4,728 | 2003 | 3/27/2003 | Finance | Real Estate Investment Trusts | Prospective |
| KFS | Kingsway Financial Services Inc | Dec-03 | No | 641 | 2003 | 02/19/2004 | Finance | Property/Casualty Insurance | Method Not Specified |
| KMRT | Kmart Holding Corp | Jan-04 | No | 4,208 | 2003 | 8/29/2003 | Retail Trade | Discount Stores | Prospective |
| KNOL | Knology | Dec-03 | No | 191 | 2002 | 3/31/2003 | Electronic Technology | Communications Equipment | Prospective |
| KPN | Koninklijke PTT Nederlands | Dec-03 | No | 18,352 | 2003 | 03/12/2004 | Communications | Major Telecommunications | Retroactive Restatement |
| LAB | Labranche & Co. Inc | Dec-03 | No | 614 | 2003 | 5/15/2003 | Finance | Investment Banks/Brokers | Prospective |
| LHO | Lasalle Hotel Properties | Dec-03 | No | 543 | 2003 | 02/18/2004 | Finance | Real Estate Investment Trusts | Prospective |
| LEA | Lear Corp | Dec-03 | No | 4,403 | 2003 | 10/18/2002 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| LEE | Lee Enterprises | Sep-03 | No | 2,131 | 2003 | 7/22/2002 | Consumer Services | Publishing: Newspapers | Retroactive Restatement |
| LM | Legg Mason Inc | Mar-04 | No | 6,215 | 2003 | 11/14/2003 | Finance | Investment Banks/Brokers | Prospective |
| LEG | Leggett & Platt | Dec-03 | Yes | 4,509 | 2003 | 11/20/2002 | Consumer Durables | Home Furnishings | Prospective |
| LEH | Lehman Brothers Holdings Inc | Nov-03 | Yes | 21,421 | 2004 | 04/14/2004 | Finance | Investment Banks/Brokers | Prospective |
| LVLT | Level 3 Communications, Inc | Dec-03 | No | 2,348 | 1998 | 1998 | Technology Services | Information Technology Services | Prospective (b) |
| LBI | Liberte Investments Del | Jun-04 | No | 147 | 2003 | 11/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| LRY | Liberty Property Trust | Dec-03 | No | 3,187 | 2003 | 4/22/2003 | Finance | Real Estate Investment Trusts | Prospective |
| LECO | Lincoln Electric Holdings, Inc | Dec-03 | No | 1,284 | 2003 | 10/16/2002 | Producer Manufacturing | Industrial Machinery | Prospective |
| LNC | Lincoln National Corp | Dec-03 | Yes | 8,330 | 2003 | 8/8/2002 | Finance | Life/Health Insurance | Retroactive Restatement |
| LINN | Linn Inc | Dec-03 | No | 17 | 2003 | 5/15/2003 | Commercial Services | Financial Publishing/Services | Prospective |
| LYG | Lloyds TSB Group PLC | Dec-03 | No | 42,421 | 2003 | 6/23/2003 | Finance | Financial Conglomerates | Prospective |
| STAR | Lone Star Steakhouse & Saloon Inc | Dec-03 | No | 654 | 2002 | 4/14/2003 | Consumer Services | Restaurants | Retroactive Restatement |
| LGBW | Longbow Mining Corp | Dec-03 | No | - | 2003 | 04/09/2004 | Non-Energy Minerals | Precious Metals | Retroactive Restatement |
| LOW | Lowe's Companies, Inc | Jan-04 | Yes | 42,191 | 2003 | 8/19/2002 | Retail Trade | Home Improvement Chains | Prospective |
| LTC | LTC Properties Inc | Dec-03 | No | 288 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| LUME | Lumenis LTD | Dec-03 | No | 47 | 2003 | 3/28/2003 | Health Technology | Medical Specialties | Prospective |
| LYO | Lyondell Chemical Co. | Dec-03 | No | 3,022 | 2003 | 8/13/2002 | Process Industries | Chemicals: Specialty | Prospective |
| MTB | M & T Bank Corp | Dec-03 | No | 10,076 | 2003 | 9/19/2002 | Finance | Regional Banks | Retroactive Restatement |
| MRD | MacDermid Inc | Dec-03 | No | 1,031 | 2001 | 4/1/2001 | Process Industries | Industrial Specialties | Prospective |
| MAC | Macerich Company | Dec-03 | No | 2,537 | 2002 | 8/12/2002 | Finance | Real Estate Investment Trusts | Prospective |
| CLI | Mack Cali Realty Corp | Dec-03 | No | 2,278 | 2002 | 2/26/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MGCN | Magic Media Networks Inc | Oct-03 | No | 4 | 2002 | 2/17/2003 | Consumer Services | Movies/Entertainment | Prospective |
| MGA | Magna International Inc | Dec-03 | No | 8,001 | 2003 | 02/27/2004 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| MHR | Magnum Hunter Resources | Dec-03 | No | 759 | 2003 | 8/6/2003 | Energy Minerals | Oil & Gas Production | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date [a] | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| MHC | Manufactured Home Communities Inc | Dec-03 | No | 743 | 2003 | 5/13/2003 | Finance | Real Estate Investment Trusts | Modified Prospective |
| MFC | Manulife Financial Corp. | Dec-03 | No | 18,131 | 2003 | 04/01/2004 | Finance | Life/Health Insurance | Prospective |
| MRO | Marathon Oil | Dec-03 | Yes | 10,591 | 2003 | 9/6/2002 | Energy Minerals | Oil Refining/Marketing | Prospective |
| TUG | Maritrans Inc | Dec-03 | No | 127 | 2003 | 3/11/2003 | Transportation | Marine Shipping | Prospective |
| MAS | Masco Corp | Dec-03 | Yes | 12,877 | 2003 | 3/14/2003 | Producer Manufacturing | Building Products | Prospective |
| MXRE | Max Re Capital Ltd | Dec-03 | No | 1,065 | 2003 | 9/9/2002 | Finance | Multi-Line Insurance | Prospective |
| MAY | May Dept. Stores | Jan-04 | Yes | 9,264 | 2003 | 8/16/2002 | Retail Trade | Department Stores | Prospective |
| MBI | MBIA Inc | Dec-03 | Yes | 8,926 | 2002 | 7/29/2002 | Finance | Specialty Insurance | Modified Prospective |
| MDZ | MDS Inc | Oct-03 | No | 2,307 | 2004 | 03/04/2004 | Health Services | Services to the Health Industry | Prospective |
| MIG | Meadowbrook Insurance Group, Inc | Dec-03 | No | 164 | 2003 | 5/9/2003 | Finance | Property/Casualty Insurance | Prospective |
| MEL | Mellon Financial Corp | Dec-03 | Yes | 13,236 | 2003 | 8/13/2002 | Finance | Investment Managers | Prospective |
| MRBK | Mercantile Bankshares | Dec-03 | No | 3,421 | 1995 | 1995 | Finance | Regional Banks | Prospective (b) |
| MHX | Meristar Hospitality Corp | Dec-03 | No | 441 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MER | Merrill Lynch & Company Inc | Dec-03 | Yes | 55,190 | 2004 | 03/09/2004 | Finance | Investment Banks/Brokers | Retroactive Restatement |
| MCC | Mestek Inc | Dec-03 | No | 159 | 2003 | 5/15/2003 | Producer Manufacturing | Building Products | Prospective |
| MET | MetLife Inc | Dec-03 | Yes | 26,113 | 2003 | 8/12/2002 | Finance | Life/Health Insurance | Prospective |
| MTG | MGIC Investment Corp | Dec-03 | Yes | 7,344 | 2003 | 5/15/2003 | Finance | Property/Casualty Insurance | Prospective |
| MSCC | Microsemi Corp | Sep-03 | No | 785 | 2003 | 5/14/2003 | Electronic Technology | Semiconductors | Modified Prospective |
| MSFT | Microsoft Corp | Jun-04 | Yes | 297,278 | 2004 | 7/8/2003 | Technology Services | Packaged Software | Retroactive Restatement |
| MRR | Mid-Atlantic Realty Trust | Dec-03 | No | N/A | 2003 | 4/30/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MWFS | Mid-Wisconsin Financial Services Inc | Dec-03 | No | 49 | 2003 | 03/24/2004 | Finance | Major Banks | Prospective |
| MLS | Mills Corp | Dec-03 | No | 2,077 | 2002 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MRAE | Mirae Corp. | Dec-03 | No | 186 | N/A | 06/30/2003 | Electronic Technology | Electronic Production Equipment | Method Not Specified |
| GRO | Mississippi Chemical Corp | Jun-04 | No | 229 | 2003 | 11/19/2002 | Process Industries | Chemicals: Agricultural | Prospective |
| MOL.A | Molson Inc | Mar-04 | No | 2,988 | 2003 | 11/6/2002 | Consumer Non-Durables | Beverages: Alcoholic | Method Not Specified |
| MONM | Monmouth Capital Corp | Dec-03 | No | 21 | 2003 | 5/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MNRTA | Monmouth Real Estate Investment Corp | Sep-03 | No | 132 | 2003 | 5/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| MRH | Montpelier Re Holdings Ltd | Dec-03 | No | 2,100 | 2002 | 11/5/2002 | Finance | Property/Casualty Insurance | Method Not Specified |
| MCO | Moody's Corp | Dec-03 | Yes | 9,871 | 2003 | 12/13/2002 | Commercial Services | Financial Publishing/Services | Prospective |
| MWD | Morgan Stanley | Nov-03 | Yes | 58,291 | 2003 | 8/13/2002 | Finance | Investment Banks/Brokers | Prospective |
| NCC | National City Corp | Dec-03 | Yes | 21,295 | 2003 | 10/29/2002 | Finance | Major Banks | Prospective |
| NADS | National Diversified Services Inc. | Dec-03 | No | - | 2003 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| NFP | National Financial Partners Corp | Dec-03 | No | 1,052 | 2003 | 8/8/2003 | Commercial Services | Financial Publishing/Services | Prospective |
| NGG | National Grid Transco PLC | Mar-04 | No | 23,525 | 2003 | 6/11/2003 | Utilities | Electric Utilities | Retroactive Restatement |
| NAP | National Processing Inc | Dec-03 | No | 1,387 | 2003 | 2/19/2003 | Technology Services | Data Processing Services | Prospective |
| NWLIA | National Western Life Insurance Co | Dec-03 | No | 533 | 2003 | 5/15/2003 | Finance | Life/Health Insurance | Modified Prospective |
| NAVG | Navigators Group Inc | Dec-03 | No | 355 | 2003 | 3/10/2004 | Finance | Property/Casualty Insurance | Method Not Specified |
| NFLX | Netflix, Inc | Dec-03 | No | 1,526 | 2003 | 6/9/2003 | Retail Trade | Internet Retail | Retroactive Restatement |
| NEU | Neuberger Berman (o) | Dec-03 | No | N/A | 2003 | 7/24/2002 | Finance | Investment Managers | Prospective |
| NJR | New Jersey Resources Corp | Sep-03 | No | 1,049 | 2003 | 10/30/2002 | Utilities | Gas Distributors | Prospective |
| NMEN | New Medium Enterprises Inc. | Jun-04 | No | N/A | 2003 | 08/26/2003 | Electronic Technology | Electronic Equipment/Instruments | Method Not Specified |
| NXL | New Plan Excel Realty Trust Inc | Dec-03 | No | 2,299 | 2003 | 3/6/2003 | Finance | Real Estate Investment Trusts | Prospective |
| NSK | New Skies Satellites NV | Dec-03 | No | 845 | 2003 | 5/1/2003 | Communications | Specialty Telecommunications | Prospective |
| NXY | Nexen Inc | Dec-03 | No | 4,980 | 2003 | 7/17/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| NMR | Nomura Holdings Inc | Mar-04 | No | 33,224 | 2002 | 12/18/2002 | Finance | Investment Banks/Brokers | Modified Prospective |
| NRD | Noranda Inc | Dec-03 | No | 4,694 | 2002 | 11/19/2002 | Non-Energy Minerals | Other Metals/Minerals | Prospective |
| NTK | Nortek Holdings Inc | Dec-03 | No | N/A | 2003 | 03/30/2004 | Producer Manufacturing | Building Products | Prospective |
| NT | Nortel Networks | Dec-03 | No | 23,947 | 2003 | 1/24/2003 | Electronic Technology | Telecommunications Equipment | Prospective |
| PAL | North American Palladium | Dec-03 | No | 527 | 2003 | 03/22/2004 | Non-Energy Minerals | Precious Metals | Prospective |
| NDML.F | Northern Dynasty Minerals Ltd. | Dec-03 | No | N/A | 2002 | 07/01/2003 | Non-Energy Minerals | Other Metals/Minerals | Retroactive Restatement |
| NWAC | Northwest Airlines Corp | Dec-03 | No | 908 | 2003 | 3/20/2003 | Transportation | Airlines | Prospective |
| NFI | NovaStar Financial Inc | Dec-03 | No | 863 | 2003 | 12/28/2003 | Finance | Real Estate Investment Trusts | Method Not Specified |
| NYM | Nymagic Inc | Dec-03 | No | 261 | 2003 | 3/15/2004 | Finance | Specialty Insurance | Prospective |
| ORH | Odyssey Re Holdings Corp | Dec-03 | No | 1,655 | 2003 | 8/1/2003 | Finance | Property/Casualty Insurance | Prospective |
| ORI | Old Republic International Corp. | Dec-03 | No | 4,441 | 2003 | 8/8/2003 | Finance | Property/Casualty Insurance | Prospective |
| OMG | OM Group Inc | Dec-03 | No | 824 | 2003 | 12/24/2003 | Process Industries | Chemicals: Specialty | Prospective |
| OMM | OMI Corp | Dec-03 | No | 923 | 2003 | 11/10/2003 | Industrial Services | Oilfield Services/Equipment | Prospective |
| OMC | Omnicom Group Inc | Dec-03 | Yes | 15,183 | 2004 | 03/16/2004 | Commercial Services | Advertising/Marketing Services | Retroactive Restatement |
| ONCY | Oncolytics Biotech Inc | Dec-03 | No | 207 | 2003 | 11/18/2003 | Health Technology | Biotechnology | Prospective |
| OKE | Oneok Inc | Dec-03 | No | 2,247 | 2003 | 2/21/2003 | Utilities | Gas Distributors | Prospective |
| OPMR | Optimal Group Inco | Dec-03 | No | 107 | 2003 | 3/31/2003 | Electronic Technology | Electronic Equipment/Instruments | Prospective |
| ORNGF.PK | Orange PLC (v) | Dec-03 | No | 1,018 | 2002 | 6/24/2003 | Communications | Wireless Telecommunications | Modified Prospective |
| OHB | Orleans Homebuilders Com | Jun-04 | No | 312 | 2003 | 9/23/2003 | Consumer Durables | Homebuilding | Prospective |
| PCAR | PACCAR Inc | Dec-03 | Yes | 10,479 | 2003 | 9/24/2002 | Producer Manufacturing | Trucks/Construction/Farm Machinery | Prospective |
| PHS | PacifiCare Health Systems | Dec-03 | No | 3,514 | 2003 | 4/30/2003 | Health Services | Managed Health Care | Prospective |
| SPOT | Pamamsat Corp | Dec-03 | No | 3,460 | 2003 | 3/6/2003 | Communications | Specialty Telecommunications | Prospective |
| PZZA | Papa John's International, Inc | Dec-03 | No | 609 | 2002 | 7/30/2002 | Consumer Services | Restaurants | Prospective |
| PLLL | Parallel Petroleum Corp | Dec-03 | No | 115 | 2003 | 10/31/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| PRE | Partnerre Limited | Dec-03 | No | 3,027 | 2003 | 8/13/2003 | Finance | Multi-Line Insurance | Prospective |
| PMRT | Pawnmart Inc. | Jan-04 | No | 0 | 2003 | 5/15/2003 | Finance | Finance/Rental/Leasing | Retroactive Restatement |
| PSO | Pearson PLC | Dec-03 | No | 9,477 | N/A | 8/7/2000 | Consumer Services | Publishing: Books/Magazines | Prospective |
| PNG | Penn-America Group, Inc | Dec-03 | No | 209 | 2003 | 8/7/2003 | Finance | Property/Casualty Insurance | Modified Prospective |
| PEI | Pennsylvania REIT | Dec-03 | No | 1,169 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Modified Prospective |
| PEP | Pepsico Inc | Dec-03 | Yes | 94,036 | 2003 | 12/22/2003 | Consumer Non-Durables | Food: Major Diversified | Retroactive Restatement |
| PRGO | Perrigo Co. | Jun-04 | No | 1,536 | 2003 | 1/24/2003 | Health Technology | Pharmaceuticals: Other | Retroactive Restatement |
| PGH | Personal Group Holdings PLC | Dec-03 | No | 101 | 2003 | 03/03/2004 | Finance | Miscellaneous | Prospective |
| PCZ | Petro-Canada | Dec-03 | No | 12,060 | 2003 | 01/28/2004 | Energy Minerals | Integrated Oil | Prospective |
| PSJ | Petsec Energy Ltd | Dec-03 | No | 5,398 | N/A | 06/27/2003 | Energy Minerals | Oil & Gas Production | Method Not Specified |
| PHG | Philips Electronics KON | Dec-03 | No | 37,196 | 2003 | 02/23/2004 | Producer Manufacturing | Industrial Conglomerates | Prospective |
| PNX | Phoenix Companies Inc | Dec-03 | No | 1,240 | 2003 | 5/15/2003 | Finance | Life/Health Insurance | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| PNW | Pinnacle West Capital Corp | Dec-03 | Yes | 3,648 | 2002 | 11/14/2002 | Utilities | Electric Utilities | Prospective |
| PJC | Piper Jaffray Companies | Dec-03 | No | 1,041 | 2003 | 6/25/2003 | Finance | Investment Banks/Brokers | Prospective |
| PDG | Placer Dome Inc | Dec-03 | No | 6,199 | 2003 | 03/05/2004 | Non-Energy Minerals | Precious Metals | Prospective |
| PCL | Plum Creek Timber Co. | Dec-03 | Yes | 5,587 | 2002 | 9/22/2002 | Finance | Real Estate Investment Trusts | Prospective |
| PMC | PMC Capital Inc | Dec-03 | No | 2,691 | 2003 | 3/31/2003 | Miscellaneous | Investment Trusts/Mutual Funds | Prospective |
| PCC | PMC Commercial Trust | Dec-03 | No | 149 | 2003 | 3/31/2003 | Finance | Real Estate Investment Trusts | Prospective |
| PNC | PNC Financial Services Group, Inc | Dec-03 | Yes | 14,847 | 2003 | 9/30/2002 | Finance | Major Banks | Prospective |
| PPP | Pogo Producing Company | Dec-03 | No | 3,036 | 2003 | 8/9/2002 | Energy Minerals | Oil & Gas Production | Prospective |
| BPOP | Popular, Inc | Dec-03 | No | 5,515 | 2002 | 10/9/2002 | Finance | Major Banks | Method Not Specified |
| PRAA | Portfolio Recovery Association Inc | Dec-03 | No | 414 | 2002 | 3/17/2003 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| PPS | Post Properties Inc | Dec-03 | No | 1,060 | 2003 | 5/15/2003 | Finance | Real Estate Investment Trusts | Prospective |
| POT | Potash Corp of Saskatchewan Inc. | Dec-03 | No | 4,565 | 2003 | 2/5/2004 | Process Industries | Chemicals: Agricultural | Prospective |
| PPG | PPG Industries Inc | Dec-03 | Yes | 10,646 | 2004 | 2/20/2004 | Process Industries | Industrial Specialties | Modified Prospective |
| PPL | PPL Corp | Dec-03 | Yes | 7,823 | 2003 | 10/4/2002 | Utilities | Electric Utilities | Prospective |
| PRDS | Predictive Systems Inc (p) | Dec-03 | No | N/A | 2002 | 9/19/2002 | Technology Services | Information Technology Services | Prospective |
| PCO | Premcor | Dec-03 | No | 2,581 | 2002 | 8/6/2002 | Energy Minerals | Oil Refining/Marketing | Prospective |
| PP | Prentiss Properties Trust | Dec-03 | No | 1,436 | 2003 | 3/28/2003 | Finance | Real Estate Investment Trusts | Prospective |
| PSMT | PriceSmart | Aug-03 | No | 51 | 2003 | 8/5/2002 | Retail Trade | Discount Stores | Prospective |
| PRM | Primedia Company Inc | Dec-03 | No | 702 | 2003 | 2/5/2004 | Consumer Services | Publishing: Books/Magazines | Prospective |
| PFG | Principal Financial Group | Dec-03 | Yes | 11,283 | 2002 | 8/7/2002 | Finance | Financial Conglomerates | Prospective |
| PG | Procter & Gamble (q) | Jun-04 | Yes | 135,689 | N/A | 8/5/2002 | Consumer Non-Durables | Household/Personal Care | Not Adopted |
| PGR | Progressive Corp Ohio | Dec-03 | Yes | 19,262 | 2003 | 5/12/2003 | Finance | Property/Casualty Insurance | Prospective |
| PL | Protective Life | Dec-03 | No | 2,529 | 1995 | 1995 | Finance | Life/Health Insurance | Prospective (b) |
| PRVD | Provide Commerce Inc. | Jun-04 | No | 257 | 2003 | 9/22/2003 | Retail Trade | Catalog & Mail Order | Prospective |
| PVX | Provident Energy Trust | Dec-03 | No | 689 | 2003 | 03/22/2004 | Finance | Miscellaneous | Prospective |
| PFGI | Provident Financial Group, Inc | Dec-03 | No | 1,957 | 2003 | 1/15/2003 | Finance | Regional Banks | Prospective |
| PRU | Prudential Financial Inc | Dec-03 | Yes | 23,865 | 2003 | 8/13/2002 | Finance | Financial Conglomerates | Prospective |
| PSB | PS Business Parks, Inc | Dec-03 | No | 845 | 2002 | 9/9/2002 | Finance | Real Estate Investment Trusts | Prospective |
| PSA | Public Storage Inc | Dec-03 | No | 5,408 | 2002 | 11/14/2002 | Finance | Real Estate Investment Trusts | Prospective |
| PHM | Pulte Homes, Inc | Dec-03 | Yes | 6,059 | 2003 | 3/17/2003 | Consumer Durables | Homebuilding | Prospective |
| QZMRE | Quartz Mountain Resources Ltd. | Jul-03 | No | 40,051 | 2003 | 2/3/2004 | Non-Energy Minerals | Precious Metals | Prospective |
| IQW | Quebecor World Inc | Dec-03 | No | 2,309 | 2003 | 2/6/2004 | Commercial Services | Commercial Printing/Forms | Prospective |
| QUIP | Quipp Inc | Dec-03 | No | 21 | 2003 | 3/14/2003 | Producer Manufacturing | Industrial Machinery | Prospective |
| RAE | Rae Systems Inc | Dec-03 | No | 318 | 2003 | 5/8/2003 | Technology Services | Internet Software/Services | Modified Prospective |
| RAVN | Raven Industries | Jan-04 | No | 294 | 2002 | 8/20/2002 | Producer Manufacturing | Miscellaneous Manufacturing | Modified Prospective |
| RJF | Raymond James Financial | Sep-03 | No | 1,891 | 2003 | 2/3/2003 | Finance | Investment Banks/Brokers | Modified Prospective |
| RCNC | RCN Corp | Dec-03 | No | 33 | 2000 | 2000 | Communications | Major Telecommunications | Prospective (b) |
| O | Realty Income | Dec-03 | No | 1,456 | 2002 | 7/26/2002 | Finance | Real Estate Investment Trusts | Prospective |
| RA | Reckson Associated Realty Corp | Dec-03 | No | 1,633 | 2002 | 12/16/2002 | Finance | Real Estate Investment Trusts | Prospective |
| RFCG | Refocus Group Inc | Dec-03 | No | 19 | 2002 | 3/19/2003 | Health Technology | Medical Specialties | Modified Prospective |
| RGA | Reinsurance Group of America, Inc | Dec-03 | No | 2,498 | 2003 | 1/30/2003 | Finance | Life/Health Insurance | Prospective |
| RNR | RenaissanceRe Holdings Ltd | Dec-03 | No | 3,806 | 2003 | 10/14/2002 | Finance | Property/Casualty Insurance | Prospective |
| RBNC | Republic Bancorp Inc | Dec-03 | No | 861 | 2003 | 3/21/2003 | Finance | Regional Banks | Prospective |
| REPB | Republic Bancshares Inc | Dec-03 | No | N/A | 2003 | 11/14/2003 | Finance | Regional Banks | Prospective |
| RVP | Retractable Technologies Inc | Dec-03 | No | 164 | 2002 | 11/14/2002 | Health Technology | Medical Specialties | Prospective |
| REY | Reynolds & Reynolds Company | Sep-03 | No | 2,350 | 2003 | 12/12/2003 | Technology Services | Information Technology Services | Retroactive Restatement |
| RFS | RFS Hotel Investors, Inc (r ) | Dec-03 | No | N/A | 2003 | 8/1/2002 | Finance | Real Estate Investment Trusts | Prospective |
| RBA | Ritchie Brothers Auctioneers | Dec-03 | No | 969 | 2003 | 02/26/2004 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| RAD | Rite Aid Corp | Feb-04 | No | 2,778 | 2004 | 7/3/2003 | Retail Trade | Drugstore Chains | Modified Prospective |
| RJR | RJ Reynolds Tobacco Holdings Inc | Dec-03 | Yes | 4,972 | 2003 | 5/15/2003 | Consumer Non-Durables | Tobacco | Prospective |
| ROH | Rohm & Haas Co. | Dec-03 | Yes | 8,858 | 2003 | 3/17/2003 | Process Industries | Chemicals: Major Diversified | Prospective |
| RONC | Ronson Corp | Dec-03 | No | 10 | 2003 | 11/14/2003 | Electronic Technology | Aerospace & Defense | Prospective |
| RSA | Royal & Sun Alliance Insurance Group PLC | Dec-03 | No | 4,389 | 2002 | 6/27/2003 | Finance | Multi-Line Insurance | Modified Prospective |
| RY | Royal Bank Of Canada | Oct-03 | No | 29,675 | 2003 | 12/4/2003 | Finance | Major Banks | Prospective |
| RYG | Royal Group Technologies | Sep-03 | No | 1,103 | 2003 | 2/5/2004 | Producer Manufacturing | Building Products | Prospective |
| RUSM | Russel Metals Inc | Dec-03 | No | 307 | 2003 | 2/6/2004 | Distribution Services | Wholesale Distributors | Prospective |
| RML | Russell Corp | Dec-03 | No | 810 | 2003 | 5/21/2003 | Consumer Non-Durables | Apparel/Footwear | Prospective |
| SKFB | S And K Famous Brands | Jan-04 | No | 43 | 2003 | 04/13/2004 | Retail Trade | Apparel/Footwear Retail | Prospective |
| SAFC | Safeco Corp | Dec-03 | Yes | 6,196 | 2003 | 10/25/2002 | Finance | Multi-Line Insurance | Prospective |
| SKS | Saks Inc | Jan-04 | No | 2,434 | 2003 | 8/20/2002 | Retail Trade | Department Stores | Prospective |
| SHS | Sauer-Danfoss Inc | Dec-03 | No | 726 | 2003 | 8/13/2003 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| BFS | Saul Centres Inc | Dec-03 | No | 413 | 2003 | 8/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| SBC | SBC Communication | Dec-03 | Yes | 84,096 | 2002 | 1/28/2003 | Communications | Major Telecommunications | Retroactive Restatement |
| BUNZ | Schlotzskys Inc | Dec-03 | No | 14 | 2003 | 8/13/2002 | Consumer Services | Restaurants | Prospective |
| SLB | Schlumberger Ltd | Dec-03 | Yes | 36,321 | 2003 | 7/23/2003 | Industrial Services | Oilfield Services/Equipment | Prospective |
| SCT | Scottish Annuity & Life Holdings Ltd | Dec-03 | No | 813 | 2003 | 6/12/2003 | Finance | Life/Health Insurance | Modified Prospective |
| SMG | Scotts Co. | Sep-03 | No | 2,167 | 2003 | 7/25/2002 | Process Industries | Chemicals: Agricultural | Prospective |
| SCST | SCS Transportation Inc | Dec-03 | No | 347 | 2003 | 4/30/2003 | Transportation | Trucking | Prospective |
| SNBJ | Security Bank Corp | Dec-03 | No | 40,051 | 2002 | 2/28/2003 | Finance | Regional Banks | Prospective |
| SECX | SED International Holdings Inc | Jun-04 | No | 8 | 2003 | 2/14/2003 | Distribution Services | Electronics Distributors | Prospective |
| SVM | ServiceMaster | Dec-03 | No | 3,501 | 2003 | 7/31/2002 | Consumer Services | Other Consumer Services | Prospective |
| SJR | Shaw Communications Inc | Aug-03 | No | 3,807 | 2004 | 04/05/2004 | Consumer Services | Cable/Satellite TV | Prospective |
| SI | Siemens AG | Sep-03 | No | 68,629 | 2003 | 12/5/2003 | Producer Manufacturing | Industrial Conglomerates | Prospective |
| SPG | Simon Property | Dec-03 | Yes | 10,095 | 2002 | 7/31/2002 | Finance | Real Estate Investment Trusts | Prospective |
| SSD | Simpson Manufacturing Co, Inc | Dec-03 | No | 1,243 | 2003 | 5/8/2003 | Producer Manufacturing | Building Products | Prospective |
| SFD | Smithfield Foods, Inc | Apr-04 | No | 3,088 | 2002 | 8/22/2002 | Consumer Non-Durables | Food: Meat/Fish/Dairy | Prospective |
| SSCC | Smurfit-Stone Container Corp | Dec-03 | No | 4,617 | 2003 | 6/12/2003 | Process Industries | Containers/Packaging | Prospective |
| SONX | Sonex Research Inc | Dec-03 | No | 3 | 2003 | 5/29/2003 | Industrial Services | Environmental Services | Modified Prospective |
| SBNK | Sonoma Valley Bancorp | Dec-03 | No | 51 | 2003 | 3/25/2003 | Finance | Savings Banks | Prospective |
| SWHI | SonomaWest Holdings Inc | Jun-04 | No | 11 | 2002 | 2002 | Finance | Real Estate Development | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date [a] | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| SJI | South Jersey Industries Inc | Dec-03 | No | 557 | 2003 | 8/14/2003 | Utilities | Gas Distributors | Prospective |
| SUG | Southern Union Panhandle Corp | Jun-04 | No | 1,455 | 2002 | 5/30/2003 | Utilities | Gas Distributors | Prospective |
| SWWC | Southwest Water Co. | Dec-03 | No | 202 | 2002 | 3/28/2003 | Utilities | Water Utilities | Retroactive Restatement |
| SOV | Sovereign Bancorp | Dec-03 | No | 5,818 | 2002 | 7/19/2002 | Finance | Savings Banks | Prospective |
| FON | Sprint FON Group | Dec-03 | Yes | 16,840 | 2003 | 8/12/2003 | Communications | Major Telecommunications | Prospective |
| PCS | Sprint PCS Group | Dec-03 | Yes | 9,910 | 2003 | 5/14/2003 | Communications | Wireless Telecommunications | Prospective |
| SJOE | St.Joseph Capital Corp. | Dec-03 | No | 39 | 2003 | 03/29/2004 | Finance | Regional Banks | Prospective |
| SFG | Stancorp Financial Group, Inc | Dec-03 | No | 1,834 | 2003 | 1/30/2003 | Finance | Life/Health Insurance | Prospective |
| STSI | Star Scientific Inc | Dec-03 | No | 179 | 1999 | 1999 | Consumer Non-Durables | Tobacco | Prospective (b) |
| SRFDF | Starfield Resources Inc. | Feb-04 | No | N/A | 2003 | 02/05/2004 | Non-Energy Minerals | Other Metals/Minerals | Prospective |
| SCX | Starrett LS Company | Jun-03 | No | 106 | 2003 | 11/7/2003 | Consumer Durables | Tools & Hardware | Prospective |
| STT | State Street Corp | Dec-03 | Yes | 16,835 | 2003 | 8/13/2002 | Finance | Financial Conglomerates | Prospective |
| SCTP | Steel City Productions Inc (u) | Dec-03 | No | - | 2003 | 3/31/2003 | Retail Trade | Specialty Stores | Prospective |
| SCS | Steelcase Inc | Feb-04 | No | 1,961 | 2004 | 9/23/2002 | Producer Manufacturing | Office Equipment & Supplies | Prospective |
| STCS | Sterling Construction Company, Inc (u) | Dec-03 | No | 1,018 | 2003 | 8/14/2003 | Distribution Services | Wholesale Distributors | Prospective |
| SRI | Stoneridge | Dec-03 | No | 342 | 2003 | 03/15/2004 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| SGLBF | Stratos Global Corp | Dec-03 | No | 405 | 2003 | 1/22/2004 | Communications | Specialty Telecommunications | Prospective |
| STU | Student Loan Corp | Dec-03 | No | 2,876 | 2003 | 3/25/2003 | Finance | Finance/Rentals/Leasing | Prospective |
| SMT | Summit Properties Inc | Dec-03 | No | 701 | 2003 | 3/17/2003 | Finance | Real Estate Investment Trusts | Prospective |
| SLC | Sun Life Financial Services of Canada | Dec-03 | No | 18,100 | 2002 | 7/31/2002 | Finance | Financial Conglomerates | Prospective |
| SUN | Sunoco, Inc | Dec-03 | Yes | 4,809 | 2002 | 9/11/2002 | Energy Minerals | Oil Refining/Marketing | Modified Prospective |
| STI | SunTrust Banks, Inc | Dec-03 | Yes | 19,695 | 2002 | 8/13/2002 | Finance | Major Banks | Prospective |
| TNX | Tan Range Explorations Corp. | Dec-03 | No | N/A | 2003 | 03/15/2004 | Non-Energy Minerals | Precious Metals | Prospective |
| SKT | Tanger Factory Outlet Centers | Dec-03 | No | 516 | 2003 | 5/6/2003 | Finance | Real Estate Investment Trusts | Modified Prospective |
| TGT | Target Corp | Jan-04 | Yes | 40,849 | 2003 | 4/10/2003 | Retail Trade | Discount Stores | Prospective |
| TARR | Tarragon Realty Investors | Dec-03 | No | 279 | 2002 | 8/5/2002 | Finance | Real Estate Investment Trusts | Prospective |
| TCO | Taubman Centers, Inc | Dec-03 | No | 1,026 | 2003 | 3/24/2003 | Finance | Real Estate Investment Trusts | Prospective |
| TBWC | TB Woods Corp. | Dec-03 | No | 41 | 2003 | 5/2/2003 | Producer Manufacturing | Industrial Machinery | Modified Prospective |
| TCB | TCF Financial Corp | Dec-03 | No | 3,536 | 2000 | 2000 | Finance | Regional Banks | Prospective (b) |
| TNL | Technitrol, Inc | Dec-03 | No | 928 | 2003 | 10/21/2002 | Electronic Technology | Electronic Components | Prospective |
| TKN | Telexion Corp | Nov-03 | No | N/A | 2003 | 7/8/2003 | Producer Manufacturing | Office Equipment & Supplies | Prospective |
| TLSN | TeliaSonera AB | Dec-03 | No | 20,903 | 2002 | 6/30/2003 | Communications | Major Telecommunications | Retroactive Restatement |
| TELM | Tellium Inc (s) | Dec-03 | No | 1,018 | 2003 | 8/15/2003 | Electronic Technology | Telecommunications Equipment | Prospective |
| TBC | Tembec Inc. | Sep-03 | No | N/A | 2004 | 02/13/2004 | Non-Energy Minerals | Forest Products | Prospective |
| TIN | Temple-Inland | Dec-03 | Yes | 3,527 | 2003 | 8/5/2002 | Process Industries | Containers/Packaging | Prospective |
| THC | Tenet Healthcare Corp | Dec-03 | Yes | 5,306 | 2003 | 3/18/2003 | Health Services | Hospital/Nursing Management | Retroactive Restatement |
| HRZ | The Hertz Corp (k) | Dec-03 | No | N/A | 2003 | 3/18/2003 | Finance | Finance/Rentals/Leasing | Modified Prospective |
| PHC | The Peoples Holding Company | Dec-03 | No | 273 | 2002 | 11/19/2002 | Finance | Regional Banks | Method Not Specified |
| TII | Thomas Industries Inc | Dec-03 | No | 598 | 2003 | 03/12/2004 | Producer Manufacturing | Electrical Products | Prospective |
| AXLE | TJT Inc | Sep-03 | No | 3 | 2004 | 02/13/2004 | Industrial Services | Environmental Services | Prospective |
| TOD | Todd Shipyards Corp | Mar-04 | No | 96 | 2003 | 6/10/2003 | Producer Manufacturing | Metal Fabrication | Prospective |
| TORM | TOR Minerals International Inc | Dec-03 | No | 37 | 2003 | 5/14/2003 | Process Industries | Industrial Specialties | Modified Prospective |
| TD | Toronto Dominion Bank | Oct-03 | No | 21,545 | 2003 | 3/26/2003 | Finance | Major Banks | Prospective |
| TOPTF | Trans Orient Petroleum Limited | Jul-03 | No | 2 | 2002 | 01/30/2004 | Energy Minerals | Oil & Gas Production | Prospective |
| TAC | Transalta Corp | Dec-03 | No | 2,417 | 2003 | 3/28/2003 | Utilities | Electric Utilities | Method Not Specified |
| TRH | Transatlantic Holdings | Dec-03 | No | 4,802 | 2003 | 3/28/2003 | Finance | Property/Casualty Insurance | Prospective |
| TRP | Transcanada Pipelines Limited | Dec-03 | No | 9,680 | 2002 | 03/15/2004 | Industrial Services | Oilfield Services/Equipment | Prospective |
| RIG | Transocean Inc | Dec-03 | Yes | 8,766 | 2003 | 3/25/2003 | Industrial Services | Contract Drilling | Prospective |
| TAP.B | Travelers Property Casualty Corp (n) | Dec-03 | Yes | N/A | 2003 | 10/16/2002 | Finance | Property/Casualty Insurance | Prospective |
| TRZ | Trizec Properties Inc | Dec-03 | No | 2,168 | 2003 | 11/6/2003 | Finance | Real Estate Investment Trusts | Prospective |
| TRMK | Trustmark Corp | Dec-03 | No | 1,588 | 2003 | 3/21/2003 | Finance | Regional Banks | Prospective |
| TMLV | Tumi Resources Ltd | Dec-03 | No | 40,051 | 2003 | 7/31/2003 | Non-Energy Minerals | Metals Mining | Prospective |
| TUP | Tupperware International | Dec-03 | Yes | 1,126 | 2003 | 8/6/2002 | Consumer Durables | Home Furnishings | Prospective |
| UCI | Ulci | Dec-03 | No | 701 | 2003 | 3/28/2003 | Finance | Life/Health Insurance | Prospective |
| UIL | UIL Holdings Corp | Dec-03 | No | 685 | 2003 | 2/28/2003 | Utilities | Electric Utilities | Prospective |
| UMH | United Mobile Homes, Inc | Dec-03 | No | 121 | 2003 | 5/14/2003 | Finance | Real Estate Investment Trusts | Prospective |
| UNBJ | United National Bancorp (l) | Dec-03 | No | N/A | 2002 | 3/20/2003 | Finance | Regional Banks | Retroactive Restatement |
| UPS | United Parcel Service Inc | Dec-03 | Yes | 80,902 | 2003 | 8/14/2002 | Transportation | Air Freight/Couriers | Prospective |
| UTR | Unitrin, Inc | Dec-03 | No | 2,901 | 2003 | 4/10/2003 | Finance | Multi-Line Insurance | Prospective |
| UCL | Unocal Corp | Dec-03 | Yes | 10,077 | 2003 | 8/11/2003 | Energy Minerals | Oil & Gas Production | Prospective |
| UNM | Unumprovident Corp | Dec-03 | Yes | 4,501 | 2003 | 2/6/2004 | Finance | Life/Health Insurance | Prospective |
| UAIR | US Airways Group, Inc | Dec-03 | No | 148 | 2003 | 8/14/2003 | Transportation | Airlines | Prospective |
| USB | US Bancorp | Dec-03 | Yes | 49,697 | 2004 | 1/20/2004 | Finance | Regional Banks | Retroactive Restatement |
| VLY | Valley National Bancorp | Dec-03 | No | 2,551 | 2002 | 7/17/2002 | Finance | Regional Banks | Prospective |
| VMDC | VantageMed Corp | Dec-03 | No | 13 | 2003 | 5/15/2003 | Health Services | Services to the Health Industry | Prospective |
| VNDC | Vendingdata Corp | Dec-03 | No | 73 | 2003 | 8/18/2003 | Electronic Technology | Electronic Equipment/Instruments | Prospective |
| VZ | Verizon Communications Inc | Dec-03 | Yes | 105,112 | 2003 | 12/5/2002 | Communications | Major Telecommunications | Prospective |
| VLGEA | Village Supermarket Inc | Jul-03 | No | 98 | 2003 | 6/6/2003 | Retail Trade | Food Retail | Prospective |
| VPI | Vintage Petroleum Inc | Dec-03 | No | 979 | 2003 | 03/12/2004 | Energy Minerals | Oil & Gas Production | Prospective |
| VC | Visteon Corp | Dec-03 | Yes | 1,379 | 2003 | 10/18/2002 | Producer Manufacturing | Auto Parts: OEM | Prospective |
| VTST | Vitalstate Inc. | Dec-03 | No | 5,398 | 2003 | 03/30/2004 | Distribution Services | Wholesale Distributors | Method Not Specified |
| VVN | Vitran Inc | Dec-03 | No | 184 | 2003 | 03/23/2004 | Transportation | Trucking | Prospective |
| VNO | Vornado Realty Trust | Dec-03 | No | 6,212 | 2003 | 8/7/2002 | Finance | Real Estate Investment Trusts | Prospective |
| WHI | W Holding Co. Inc | Dec-03 | No | 1,859 | 2003 | 3/31/2003 | Finance | Savings Banks | Modified Prospective |
| BER | W R Berkley Corp | Dec-03 | No | 3,489 | 2003 | 5/15/2003 | Finance | Property/Casualty Insurance | Prospective |
| WPL | W.P. Stewart & Co., Ltd | Dec-03 | No | 917 | 2003 | 7/31/2002 | Finance | Investment Managers | Prospective |
| WB | Wachovia | Dec-03 | Yes | 61,192 | 2002 | 7/18/2002 | Finance | Major Banks | Prospective |
| WMT | Wal-Mart Stores Inc | Jan-04 | Yes | 252,908 | 2003 | 8/14/2003 | Retail Trade | Discount Stores | Retroactive Restatement |
| WRNC | Warnaco Group, Inc | Dec-03 | No | 951 | 2003 | 5/15/2003 | Consumer Non-Durables | Apparel/Footwear | Prospective |
| WM | Washington Mutual, Inc | Dec-03 | Yes | 34,862 | 2003 | 1/29/2003 | Finance | Savings Banks | Prospective |

**APPENDIX A: Companies that Currently Expense or Intend to Expense Stock Options using the Fair Value Method (Continued)**

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**April 28, 2004**

**($ in millions)**

| Ticker | Company | Year End | S&P 500 | Market Capitalization | Adoption Year | Announcement Date (a) | Sector | Industry | Method Adopted |
|---|---|---|---|---|---|---|---|---|---|
| WPO | Washington Post Co | Dec-03 | No | 8,904 | 2002 | 7/15/2002 | Consumer Services | Publishing: Newspapers | Prospective |
| WFT | Weatherford International Ltd | Dec-03 | No | 5,843 | 2003 | 1/30/2004 | Industrial Services | Oilfield Services/Equipment | Prospective |
| WBST | Webster Financial | Dec-03 | No | 2,129 | 2002 | 7/24/2002 | Finance | Savings Banks | Prospective |
| WRI | Weingarten Realty Investors | Dec-03 | No | 2,457 | 2003 | 3/17/2003 | Finance | Real Estate Investment Trusts | Prospective |
| WRP | Wellsford Real Properties, Inc | Dec-03 | No | 113 | 2003 | 5/6/2003 | Finance | Real Estate Development | Prospective |
| WBKC | Westbank Corp. | Dec-03 | No | 102 | 2003 | 03/08/2004 | Finance | Regional Banks | Prospective |
| WBK | Westpac Banking Corp. | Sep-03 | No | 23,949 | 2002 | 11/07/2003 | Finance | Major Banks | Prospective |
| WFSI | WFS Financial Inc | Dec-03 | No | 1,844 | 2003 | 6/11/2003 | Finance | Finance/Rental/Leasing | Prospective |
| WHT | Wheaton River Minerals Limited | Dec-03 | No | 1,308 | 2004 | 03/15/2004 | Non-Energy Minerals | Precious Metals | Method Not Specified |
| WINA | Winmark Corp | Dec-03 | No | 151 | 2002 | 3/19/2003 | Retail Trade | Specialty Stores | Prospective |
| WIN | Wine-Dixie Stores Inc | Jun-04 | Yes | 1,138 | 1996 | 1996 | Retail Trade | Food Retail | Prospective (b) |
| INT | World Fuel Services | Dec-03 | No | 476 | 2002 | 8/1/2002 | Commercial Services | Miscellaneous Commercial Services | Prospective |
| XL | XL Capital Ltd | Dec-03 | Yes | 10,834 | 2003 | 2/11/2003 | Finance | Property/Casualty Insurance | Prospective |
| YCC | Yankee Candle Co. Inc | Dec-03 | No | 1,313 | 2003 | 10/22/2003 | Consumer Non-Durables | Consumer Sundries | Prospective |
| ZNT | Zenith National Insurance Corp | Dec-03 | No | 866 | 2002 | 3/14/2003 | Finance | Multi-Line Insurance | Prospective |
| ZHNE | Zhone Technologies Inc (s) | Dec-03 | No | 280 | 2003 | 5/1/2003 | Electronic Technology | Telecommunications Equipment | Prospective |

*Source: Company reports and press releases; FactSet Research Systems Inc.; Bear Stearns estimates.*

N/A - Information not available

(a) Announcement dates listed represent the earliest date we were able to identify the company announcing that it intended to adopt the fair value method.
(b) The company adopted FAS No. 123 before the issuance of FAS No. 148, therefore, the prospective method was the only method of adoption available to the company.
(c) In a July 23, 2002 press release, Amazon stated that "The Company announced that by the beginning of 2003 all stock-based awards granted thereafter will be expensed." To date, the company has not formally adopted the fair value method. The company has not granted any options in 2003. It has used other compensation methods such as restricted stock which are expensed regardless of whether a company adopts the fair value method for stock option grants.
(d) Avis Group was acquired by Cendant in March 2001.
(e) On July 10, 2003, Great-West Lifeco Inc completed its acquisition of Canada Life Financial Corporation.
(f) On October 20, 2003, Cathay Bancorp, Inc. and GBC Bancorp completed their merger.
(g) In July 2003, CBRE Holdings Inc. and Insignia Financial Group, Inc merged operations.
(h) On March 28, 2003, Dole Food Company, Inc. (NYSE: DOL) became a private company when it was acquired by David H. Murdock, Dole's Chairman and Chief Executive Officer.
(i) Expedia is a subsidiary of Interactive Corp.
(j) Rather than grant stock options or stock appreciation rights (SARs), Exxon Mobil granted 11.072 million shares of restricted common stock and restricted common stock units in November 2002.
(k) On March 9, 2001, Hertz became a wholly owned subsidiary of Ford when Ford reacquired the outstanding 18.5% of Hertz' stock.
(l) H&R Block stated that it intends to begin expensing the cost of stock options in its next fiscal year, assuming that the Financial Accounting Standards Board (FASB) clarifies its rules on this issue.
(m) On March 28, 2003, Household was acquired by HSBC Holdings plc.
(n) On April 1, 2004, St. Paul Travelers completed the merger that combines The St. Paul Companies (NYSE:SPC) and Travelers Property Casualty Corp. (NYSE:TAP A and TAP B).
(o) On October 31, 2003, Lehman Brothers completed its acquisition of Neuberger Berman.
(p) On Thursday, 19 June 2003, Predictive Systems was acquired by International Network Services (INS) and is now a wholly owned subsidiary of INS.
(q) In an 8/5/02 conference call, Procter & Gamble said it is prepared to begin expensing options no later than fiscal 2004, but the company stopped short of guaranteeing the change. As of 2/1/04, the company was still using the intrinsic value method.
(r) On July 10, 2003, RFS Hotel Investors, Inc. was acquired by CNL Hospitality Properties, Inc. (CNL).
(s) On November 13, 2003, Zhone Technologies, Inc.and Telkium, Inc. merged. The combined company is named Zhone Technologies, Inc. and will be headquartered in Oakland, California.
(t) On January 2, 2004, the PNC Financial Services Group, Inc. acquired United National Bancorp.
(u) Steel City Products is a subsidiary of Sterling Construction Company.
(v) Equant and Orange are subsidiaries of France Telecom.
(w) In an August 28, 2002 press release, Kellwood stated that the company would begin expensing stock options in Fiscal 2003. As of December 4, 2003, the company was still applying APB 25.

**APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)**

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| Sector (# of Companies) | Industry Group Name (# of Companies) | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2001 Reported Net Income/ (Net Loss) from Cont. Oper. | 2001 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2001 Total Stock-based Compensation | 2001 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2001 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Consumer Discretionary (87) | Auto Components (6) | (308) | 17 | (69) | (360) | NM | (104) | 2 | (128) | (230) | NM | (342) | 15 | (142) | (469) | NM |
| | Automobiles (3) | 4,172 | 294 | (320) | 4,106 | -2% | 3,226 | 44 | (378) | 2,892 | -10% | 2,224 | 18 | (330) | 1,912 | -14% |
| | Distributors (1) | 354 | 0 | (6) | 348 | -2% | 368 | - | (3) | 364 | -1% | 297 | - | (3) | 294 | -1% |
| | Hotels Restaurants & Leisure (11) | 5,469 | 36 | (568) | 4,937 | -10% | 4,726 | 16 | (584) | 4,161 | -12% | 4,623 | 28 | (506) | 4,148 | -10% |
| | Household Durables (13) | 3,452 | 38 | (184) | 3,327 | -4% | 3,178 | 20 | (176) | 3,022 | -5% | 2,103 | 22 | (167) | 1,958 | -7% |
| | Internet & Catalog Retail (1) | 447 | 5 | (202) | 251 | -44% | 350 | 8 | (193) | 163 | -75% | 80 | 3 | (212) | (118) | -230% |
| | Leisure Equipment & Products (4) | 1,086 | 0 | (56) | 1,030 | -5% | 1,427 | 1 | (149) | 1,279 | -10% | 537 | 2 | (112) | 428 | -20% |
| | Media (15) | 10,776 | 83 | (1,784) | 9,098 | -16% | (35,728) | 88 | (2,235) | (37,884) | NM | (3,583) | 84 | (2,456) | (5,964) | NM |
| | Multiline Retail (11) | 6,212 | 20 | (254) | 7,978 | -3% | 6,148 | 5 | (259) | 5,887 | -4% | 4,556 | 8 | (253) | 4,311 | -5% |
| | Specialty Retail (17) | 12,304 | 84 | (827) | 11,561 | -6% | 10,164 | 91 | (789) | 9,466 | -7% | 7,295 | 52 | (789) | 6,559 | -10% |
| | Textiles, Apparel & Luxury Goods (5) | 1,904 | 8 | (106) | 1,806 | -5% | 3,728 | 9 | (113) | 3,623 | -6% | 1,338 | 2 | (94) | 1,247 | -7% |
| | Sector Total | 47,868 | 546 | (4,336) | 44,079 | -8% | (4,636) | 285 | (5,017) | (9,368) | NM | 19,147 | 233 | (5,075) | 14,306 | -25% |
| Consumer Staples (37) | Beverages (7) | 11,566 | 811 | (846) | 11,280 | -2% | 10,221 | 985 | (781) | 10,525 | -2% | 5,725 | 296 | (656) | 5,353 | -4% |
| | Food & Staples Retailing (10) | 13,795 | 140 | (490) | 13,444 | -3% | 13,470 | 113 | (489) | 13,114 | -3% | 12,871 | 113 | (425) | 11,785 | -3% |
| | Food Products (10) | 6,506 | 58 | (293) | 6,273 | -4% | 5,617 | 61 | (348) | 5,331 | -5% | 5,728 | 53 | (277) | 5,505 | -4% |
| | Household Products (4) | 8,816 | - | (519) | 8,297 | -6% | 7,683 | - | (578) | 7,106 | -8% | 6,005 | - | (498) | 5,537 | -8% |
| | Personal Products (3) | 2,212 | 1 | (137) | 2,075 | -6% | 1,890 | 1 | (149) | 1,742 | -8% | 1,479 | 1 | (143) | 1,327 | -10% |
| | Tobacco (3) | 6,239 | 10 | (33) | 6,217 | 0% | 11,821 | - | (149) | 11,671 | -1% | 9,813 | 11 | (217) | 9,607 | -2% |
| | Sector Total | 49,077 | 819 | (2,311) | 47,586 | -3% | 50,702 | 761 | (2,474) | 48,969 | -3% | 43,612 | 474 | (2,195) | 42,095 | -4% |
| Energy (23) | Energy Equipment & Services (8) | 1,549 | 14 | (222) | 1,341 | -13% | (4,318) | 13 | (310) | (4,615) | NM | 2,776 | 9 | (254) | 2,532 | -9% |
| | Oil & Gas (15) | 43,192 | 257 | (434) | 43,014 | 0% | 16,859 | 168 | (616) | 15,511 | -3% | 27,323 | 142 | (694) | 26,772 | -2% |
| | Sector Total | 44,741 | 271 | (656) | 44,355 | -1% | 11,720 | 181 | (926) | 10,976 | -6% | 30,101 | 151 | (948) | 29,304 | -3% |
| Financials (84) | Capital Markets (15) | 25,883 | 2,402 | (3,810) | 24,275 | -5% | 15,218 | 1,958 | (4,929) | 12,247 | -20% | 14,214 | 1,970 | (4,758) | 11,426 | -20% |
| | Commercial Banks (25) | 45,712 | 547 | (1,440) | 44,820 | -2% | 40,786 | 334 | (1,527) | 39,493 | -3% | 27,881 | 354 | (1,695) | 26,330 | -5% |
| | Consumer Finance (5) | 8,089 | 172 | (767) | 7,494 | -7% | 6,260 | 110 | (815) | 5,575 | -11% | 4,187 | 51 | (643) | 3,595 | -14% |
| | Diversified Financial Services (3) | 18,945 | 137 | (409) | 18,673 | -1% | 14,357 | 12 | (463) | 13,905 | -3% | 13,822 | 7 | (577) | 13,251 | -4% |
| | Insurance (24) | 28,317 | 285 | (957) | 27,643 | -2% | 18,660 | 122 | (960) | 18,023 | -4% | 11,967 | 113 | (827) | 11,253 | -6% |
| | Real Estate (8) | 1,724 | 35 | (56) | 1,702 | -1% | 2,101 | 44 | (75) | 2,071 | -1% | 4,312 | 31 | (58) | 4,284 | -1% |
| | Thrifts & Mortgage Finance (6) | 15,495 | 124 | (220) | 15,320 | -1% | 20,857 | 95 | (273) | 20,748 | -1% | 13,828 | 84 | (225) | 13,681 | -1% |
| | Sector Total | 143,966 | 3,699 | (7,728) | 139,927 | -3% | 118,630 | 2,675 | (9,132) | 112,072 | -5% | 90,011 | 2,619 | (8,779) | 83,820 | -7% |
| Health Care (47) | Biotechnology (5) | 1,720 | 8 | (519) | 1,211 | -30% | (2,075) | 16 | (478) | (2,537) | NM | 1,429 | 17 | (429) | 1,012 | -29% |
| | Health Care Equipment & Supplies (13) | 5,936 | 8 | (746) | 5,198 | -12% | 5,152 | 16 | (712) | 4,456 | -14% | 3,895 | 16 | (676) | 3,234 | -17% |
| | Health Care Providers & Services (17) | 9,315 | 161 | (1,046) | 8,428 | -10% | 7,706 | 168 | (980) | 6,894 | -11% | 5,288 | 74 | (716) | 4,647 | -12% |
| | Pharmaceuticals (12) | 26,683 | 81 | (2,736) | 24,065 | -10% | 37,323 | 82 | (2,663) | 34,712 | -7% | 31,499 | 78 | (2,842) | 28,143 | -7% |
| | Sector Total | 43,655 | 249 | (5,042) | 38,881 | -11% | 48,105 | 282 | (4,833) | 43,524 | -10% | 42,021 | 185 | (4,163) | 38,036 | -9% |
| Industrials (59) | Aerospace & Defense (8) | 8,113 | 547 | (929) | 7,731 | -5% | 7,772 | 514 | (906) | 7,381 | -5% | 6,424 | 433 | (776) | 6,081 | -5% |
| | Air Freight & Logistics (3) | 3,864 | 457 | (547) | 3,773 | -2% | 4,092 | 392 | (504) | 3,979 | -3% | 3,028 | 441 | (531) | 2,938 | -3% |
| | Airlines (2) | (331) | - | (90) | (421) | NM | (1,031) | - | (100) | (1,131) | NM | (705) | - | (55) | (760) | NM |
| | Building Products (2) | 1,140 | 41 | (73) | 1,113 | -3% | 1,035 | 21 | (60) | 996 | -4% | 498 | 20 | (56) | 462 | -7% |
| | Commercial Services & Supplies (13) | 4,670 | 12 | (299) | 4,392 | -6% | 4,122 | 5 | (612) | 3,515 | -15% | 2,778 | 20 | (536) | 2,260 | -19% |
| | Construction & Engineering (1) | 179 | - | (9) | 171 | -5% | 170 | - | (8) | 162 | -5% | 128 | - | (11) | 117 | -8% |
| | Electrical Equipment (6) | 1,771 | 8 | (78) | 1,702 | -4% | 1,413 | (0) | (90) | 1,323 | -6% | 1,224 | 2 | (138) | 1,087 | -11% |
| | Industrial Conglomerates (4) | 19,308 | 166 | (780) | 18,629 | -4% | 14,634 | 38 | (929) | 13,744 | -6% | 19,927 | 34 | (896) | 19,066 | -4% |
| | Machinery (14) | 5,936 | 54 | (315) | 5,675 | -4% | 3,858 | 11 | (297) | 3,652 | -7% | 3,216 | 16 | (280) | 2,943 | -8% |
| | Road & Rail (4) | 2,433 | 60 | (155) | 2,338 | -4% | 2,952 | 59 | (158) | 2,853 | -3% | 2,320 | 37 | (104) | 2,253 | -3% |
| | Trading Companies & Distributors (1) | 227 | - | (14) | 213 | -6% | 235 | - | (13) | 221 | -6% | 175 | - | (12) | 162 | -7% |
| | Sector Total | 47,315 | 1,284 | (3,263) | 45,316 | -4% | 39,333 | 1,041 | (3,679) | 36,695 | -7% | 39,008 | 1,002 | (3,402) | 36,609 | -6% |
| Information Technology (63) | Communications Equipment (14) | 2,796 | 109 | (3,215) | (310) | -111% | (26,242) | 217 | (6,697) | (32,122) | NM | (84,425) | 255 | (9,228) | (89,397) | NM |
| | Computers & Peripherals (10) | 9,991 | 156 | (4,129) | 6,019 | -40% | 8,112 | 238 | (6,495) | 1,855 | -76% | 10,071 | 261 | (4,448) | 5,883 | -42% |
| | Electronic Equipment & Instruments (10) | (4,467) | 22 | (1,264) | (5,709) | NM | (6,415) | (28) | (633) | (7,075) | NM | 214 | (46) | (800) | (632) | -395% |
| | Internet Software & Services (1) | 238 | 13 | (216) | 35 | -85% | 107 | 5 | (488) | (376) | -452% | (93) | 9 | (966) | (963) | NM |
| | IT Services (10) | 4,093 | 53 | (750) | 3,416 | -17% | 5,132 | 63 | (784) | 4,411 | -14% | 4,122 | 83 | (804) | 3,601 | -13% |
| | Office Electronics (1) | 302 | - | (85) | 217 | -28% | 100 | - | (83) | 17 | -83% | (145) | - | (83) | (228) | NM |
| | Semiconductor & Semiconductor Equipment (19) | 4,327 | 749 | (5,062) | 14 | -100% | (5,338) | 669 | (5,522) | (10,192) | NM | (1,675) | 677 | (4,819) | (5,817) | NM |
| | Software (17) | 13,388 | 80 | (4,476) | 8,994 | -33% | 9,039 | 143 | (5,728) | 3,454 | -62% | 9,746 | 207 | (5,552) | 4,402 | -53% |
| | Sector Total | 30,669 | 1,182 | (19,178) | 12,676 | -59% | (17,906) | 1,307 | (29,830) | (46,528) | NM | (62,183) | 1,445 | (27,296) | (83,901) | NM |
| Materials (33) | Chemicals (14) | 5,070 | 78 | (397) | 4,751 | -6% | 3,614 | 79 | (482) | 3,161 | -13% | 5,637 | 26 | (442) | 5,221 | -7% |
| | Construction Materials (1) | 229 | 3 | (7) | 219 | -2% | 197 | 1 | (5) | 192 | -2% | 242 | 0 | (4) | 238 | -2% |
| | Containers & Packaging (5) | 909 | 39 | (62) | 887 | -2% | 298 | 26 | (48) | 276 | -7% | 474 | 13 | (33) | 454 | -4% |
| | Metals & Mining (8) | 1,178 | 65 | (136) | 1,108 | -6% | 843 | 6 | (163) | 685 | -25% | 546 | 5 | (217) | 335 | -39% |
| | Paper & Forest Products (5) | 1,115 | 5 | (90) | 1,026 | -8% | 340 | 2 | (165) | 178 | -30% | (1,217) | 1 | (112) | (1,428) | NM |
| | Sector Total | 8,492 | 191 | (692) | 7,991 | -6% | 5,291 | 64 | (861) | 4,353 | -14% | 5,682 | 45 | (808) | 4,818 | -14% |
| Telecommunication Services (12) | Diversified Telecommunication Services (9) | 15,133 | 349 | (543) | 14,939 | -3% | (543) | 502 | (1,547) | (1,588) | NM | 4,027 | 496 | (1,971) | 2,551 | -37% |
| | Wireless Telecommunication Services (3) | 1,318 | 54 | (583) | 789 | -40% | (1,397) | 14 | (839) | (2,222) | NM | (3,681) | 18 | (742) | (4,405) | NM |
| | Sector Total | 16,451 | 423 | (1,448) | 15,629 | -6% | (2,040) | 516 | (2,386) | (3,811) | NM | 346 | 484 | (2,713) | (1,884) | -644% |
| Utilities (38) | Electric Utilities (22) | 12,470 | 63 | (244) | 12,289 | -1% | 13,208 | 47 | (270) | 12,985 | -2% | 13,206 | 42 | (232) | 13,016 | -1% |
| | Gas Utilities (6) | 2,140 | 27 | (62) | 2,105 | -2% | 1,895 | 9 | (47) | 1,857 | -2% | 1,397 | 12 | (48) | 1,366 | -3% |
| | Multi-Utilities & Unregulated Power (8) | 310 | 55 | (172) | 193 | -38% | (2,579) | 43 | (542) | (3,078) | NM | 5,543 | 26 | (420) | 4,649 | -8% |
| | Sector Total | 14,920 | 145 | (478) | 14,587 | -2% | 12,524 | 99 | (859) | 11,763 | -6% | 19,707 | 79 | (700) | 19,087 | -3% |
| S&P 500 Total | | 447,364 | 8,939 | (45,147) | 411,026 | -8% | 361,825 | 7,206 | (53,969) | 315,063 | -18% | 227,554 | 6,712 | (51,047) | 183,219 | -19% |

*Source: Company reports, FactSet Research Systems Inc.; Standard and Poor's; Bear Stearns estimates.*

Note: This is an update to the original table published in our March 30, 2004 First Call. In the March 30th First Call we used estimates for several January yearend companies that had not yet released their annual results. This exhibit incorporates the fiscal yearend results for the companies that have since released their 10Ks.



BEAR, STEARNS & CO. INC. 383 MADISON AVENUE NEW YORK, NY 10179 (212) 272-2000 WWW.BEARSTEARNS.COM

APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR
STEARNS

Accounting and Taxation Research
Pat McConnell, CPA (212) 272-4193
Janet Pegg, CPA (212) 272-4191
Chris Sanyek, CPA (212) 272-2509
Dane Mott (212) 272-4060

| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Consumer Discretionary*** | | | | | | | | | | | | | | | | | |
| ***Auto Components (5)*** | | | | | | | | | | | | | | | | | |
| Cooper Tire & Rubber | CTB | Dec-03 | | 73.8 | - | (2.6) | 71.3 | 1.00 | 0.96 | -3% | 111.8 | - | (3.4) | 108.4 | 1.51 | 1.46 | -3% |
| Dana Corp. | DCN | Dec-03 | | 175.0 | 2.0 | (18.0) | 161.0 | 1.17 | 1.08 | -8% | 6.0 | 3.0 | (20.0) | (11.0) | 0.04 | (0.07) | -283% |
| Delphi Corporation | DPH | Dec-03 | | (56.0) | - | (17.0) | (73.0) | (0.10) | (0.13) | 30% | 342.0 | - | (43.0) | 299.0 | 0.61 | 0.53 | -13% |
| Goodyear Tire & Rubber (b) | GT | Dec-02 | | - | - | - | - | - | - | NM | (1,105.8) | (4.9) | (34.3) | (1,145.0) | (6.62) | (6.96) | 4% |
| Johnson Controls | JCI | Sep-03 | Prospective | 582.9 | 5.5 | (15.0) | 573.4 | 7.20 | 7.10 | -1% | 600.5 | - | (12.3) | 588.2 | 6.35 | 6.22 | -2% |
| Visteon Corp. | VC | Dec-03 | Prospective | (1,194.0) | 9.0 | (18.0) | (1,193.0) | (9.65) | (9.71) | 1% | (59.9) | 4.0 | (16.0) | (76.0) | (0.68) | (0.77) | 19% |
| **Total** | | | | **(208.3)** | **16.5** | **(66.6)** | **(360.3)** | | | **NM** | **(104.3)** | **2.1** | **(128.0)** | **(230.4)** | | | **NM** |
| ***Automobiles (3)*** | | | | | | | | | | | | | | | | | |
| Ford Motor | F | Dec-03 | Modified Prospective | 549.1 | 112.0 | (112.0) | 549.1 | 0.50 | 0.50 | 0% | 970.9 | - | (179.0) | 491.9 | 0.15 | 0.05 | -27% |
| General Motors | GM | Dec-03 | Prospective | 2,862.0 | 142.0 | (195.0) | 2,809.0 | 5.03 | 4.93 | -2% | 1,975.0 | 44.0 | (187.0) | 1,832.0 | 3.51 | 3.26 | -7% |
| Harley-Davidson | HDI | Dec-03 | - | 760.8 | - | (13.4) | 747.5 | 2.50 | 2.46 | -2% | 580.2 | - | (12.2) | 568.0 | 1.90 | 1.86 | -2% |
| **Total** | | | | **4,172.1** | **254.0** | **(320.4)** | **4,105.6** | | | **-2%** | **3,326.1** | **44.0** | **(378.2)** | **2,891.9** | | | **-10%** |
| ***Distributors (1)*** | | | | | | | | | | | | | | | | | |
| Genuine Parts | GPC | Dec-03 | Prospective | 353.6 | 0.0 | (5.7) | 348.0 | 2.03 | 2.00 | -2% | 367.5 | - | (3.4) | 364.1 | 2.10 | 2.08 | -1% |
| **Total** | | | | **353.6** | **0.0** | **(5.7)** | **348.0** | | | **-2%** | **367.5** | **-** | **(3.4)** | **364.1** | | | **-1%** |
| ***Hotels Restaurants & Leisure (11)*** | | | | | | | | | | | | | | | | | |
| Carnival Corp. | CCL | Nov-03 | | 1,194.0 | 7.0 | (36.0) | 1,165.0 | 1.86 | 1.82 | -2% | 1,016.0 | 5.0 | (30.0) | 991.0 | 1.73 | 1.69 | -2% |
| Darden Restaurants | DRI | May-03 | | 232.3 | 2.8 | (19.8) | 215.1 | 1.31 | 1.22 | -7% | 237.8 | 2.7 | (18.4) | 222.1 | 1.30 | 1.21 | -7% |
| Harrah's Entertainment | HET | Dec-03 | | 292.0 | - | (23.5) | 268.4 | 2.64 | 2.43 | -8% | 323.2 | - | (20.2) | 303.0 | 2.85 | 2.67 | -6% |
| Hilton Hotels | HLT | Dec-03 | | 154.0 | - | (17.0) | 147.6 | 0.43 | 0.39 | -10% | 196.0 | - | (20.0) | 176.0 | 0.53 | 0.48 | -10% |
| International Game Technology | IGT | Sep-03 | | 376.3 | 2.7 | (21.3) | 356.7 | 1.07 | 1.02 | -5% | 254.7 | 2.1 | (18.8) | 238.2 | 0.74 | 0.69 | -6% |
| Marriott Int'l. | MAR | Dec-03 | | 476.0 | 19.0 | (73.0) | 422.0 | 1.94 | 1.73 | -11% | 439.0 | 9.0 | (64.0) | 384.0 | 1.74 | 1.54 | -13% |
| McDonald's Corp. | MCD | Dec-03 | | 1,508.2 | 4.4 | (224.1) | 1,288.5 | 1.18 | 1.01 | -15% | 992.1 | - | (251.7) | 740.4 | 0.77 | 0.57 | -25% |
| Starbucks Corp. | SBUX | Sep-03 | | 268.3 | - | (37.4) | 230.9 | 0.67 | 0.58 | -14% | 212.7 | - | (37.4) | 175.2 | 0.54 | 0.44 | -18% |
| Starwood Hotels & Resorts | HOT | Dec-03 | | 105.0 | - | (65.0) | 40.0 | 0.51 | 0.19 | -62% | 251.0 | - | (73.0) | 178.0 | 1.22 | 0.87 | -29% |
| Wendy's International | WEN | Dec-03 | | 236.0 | 0.4 | (14.8) | 221.6 | 2.06 | 1.95 | -6% | 218.8 | - | (12.0) | 206.8 | 1.89 | 1.80 | -5% |
| Yum! Brands, Inc. | YUM | Dec-03 | | 618.0 | - | (36.0) | 582.0 | 2.02 | 1.91 | -6% | 583.0 | - | (39.0) | 544.0 | 1.85 | 1.76 | -7% |
| **Total** | | | | **5,489.0** | **36.2** | **(568.9)** | **4,937.2** | | | **-10%** | **4,726.3** | **18.8** | **(564.3)** | **4,186.8** | | | **-12%** |
| ***Household Durables (13)*** | | | | | | | | | | | | | | | | | |
| American Greetings Class A | AM | Feb-03 | | 121.1 | - | (4.7) | 116.4 | 1.85 | 1.79 | -4% | (122.3) | - | (7.8) | (130.2) | (1.92) | (2.05) | 6% |
| Black & Decker Corp. | BDK | Dec-03 | | 287.2 | 2.6 | (19.3) | 270.5 | 3.58 | 3.48 | -5% | 228.5 | - | (18.5) | 210.0 | 2.82 | 2.61 | -8% |
| Centex Corp. | CTX | Mar-03 | Prospective | 559.9 | 4.2 | (24.5) | 535.7 | 8.83 | 8.49 | -4% | 382.2 | 0.5 | (25.0) | 357.8 | 6.11 | 5.72 | -6% |
| Fortune Brands, Inc. | FO | Dec-03 | | 579.2 | - | (18.2) | 561.0 | 3.96 | 3.74 | -3% | 525.9 | - | (16.3) | 509.3 | 3.41 | 3.31 | -3% |
| KB Home | KBH | Nov-03 | | 370.8 | - | (13.5) | 357.3 | 8.80 | 8.69 | -4% | 314.4 | - | (12.4) | 301.9 | 7.15 | 7.00 | -4% |
| Leggett & Platt | LEG | Dec-03 | Prospective | 205.5 | 7.5 | (9.2) | 204.2 | 1.05 | 1.04 | -1% | 233.1 | 4.9 | (11.1) | 228.9 | 1.17 | 1.14 | -3% |
| Maytag Corp. | MYG | Dec-03 | | 114.4 | - | (4.5) | 109.7 | 1.45 | 1.39 | -4% | 195.1 | - | (8.8) | 186.3 | 2.44 | 2.33 | -5% |
| Newell Rubbermaid Co | NWL | Dec-03 | | (46.6) | - | (19.0) | (65.6) | (0.17) | (0.24) | 41% | 311.5 | - | (16.3) | 295.2 | 1.16 | 1.10 | -5% |
| Pulte Homes, Inc. | PHM | Dec-03 | Prospective | 617.3 | 9.0 | (11.5) | 614.8 | 4.91 | 4.88 | 0% | 444.6 | 3.1 | (12.0) | 435.7 | 3.60 | 3.53 | -2% |
| Snap-On Inc. | SNA | Dec-03 | | 78.7 | 1.5 | (5.6) | 74.6 | 1.35 | 1.28 | -5% | 103.2 | (5.4) | (7.3) | 95.5 | 1.76 | 1.63 | -7% |
| Stanley Works | SWK | Dec-03 | | 96.7 | - | (2.2) | 94.5 | 1.14 | 1.12 | -2% | 170.3 | - | (6.4) | 161.9 | 1.93 | 1.83 | -5% |
| Tupperware Corp | TUP | Dec-03 | Prospective | 47.5 | 0.2 | (6.3) | 41.8 | 0.82 | 0.72 | -13% | 90.1 | - | (7.0) | 83.1 | 1.54 | 1.42 | -8% |
| Whirlpool Corp. | WHR | Dec-03 | | 424.0 | 13.0 | (25.0) | 412.0 | 5.91 | 5.74 | -3% | 302.0 | 12.0 | (25.0) | 289.0 | 3.78 | 3.59 | -5% |
| **Total** | | | | **3,452.5** | **38.0** | **(163.6)** | **3,328.9** | | | **-4%** | **3,178.3** | **20.1** | **(115.9)** | **3,022.5** | | | **-5%** |
| ***Internet & Catalog Retail (1)*** | | | | | | | | | | | | | | | | | |
| eBay Inc. | EBAY | Dec-03 | | 447.2 | 5.5 | (201.8) | 250.9 | 0.68 | 0.38 | -44% | 249.9 | 6.0 | (192.9) | 62.9 | 0.43 | 0.11 | -75% |
| **Total** | | | | **447.2** | **5.5** | **(201.8)** | **250.9** | | | **-44%** | **249.9** | **6.0** | **(192.9)** | **62.9** | | | **-75%** |
| ***Leisure Equipment & Products (4)*** | | | | | | | | | | | | | | | | | |
| Brunswick Corp | BC | Dec-03 | | 135.2 | - | (5.4) | 129.8 | 1.47 | 1.41 | -4% | 103.5 | - | (5.3) | 98.2 | 1.14 | 1.09 | -5% |
| Eastman Kodak | EK | Dec-03 | | 238.0 | - | (16.0) | 222.0 | 0.83 | 0.78 | -7% | 793.0 | - | (105.0) | 688.0 | 2.72 | 2.36 | -13% |
| Hasbro Inc. | HAS | Dec-03 | | 175.0 | 0.1 | (12.9) | 162.2 | 0.96 | 0.91 | -7% | 75.1 | 1.2 | (18.6) | 56.6 | 0.43 | 0.32 | -25% |
| Mattel, Inc. | MAT | Dec-03 | | 537.5 | - | (22.0) | 515.6 | 1.22 | 1.17 | -4% | 450.0 | - | (16.3) | 433.7 | 1.03 | 0.99 | -4% |
| **Total** | | | | **1,085.8** | **0.1** | **(56.3)** | **1,029.8** | | | **-5%** | **1,421.6** | **1.2** | **(149.2)** | **1,276.5** | | | **-10%** |
| ***Media (13)*** | | | | | | | | | | | | | | | | | |
| Clear Channel Communications | CCU | Dec-03 | | 1,145.6 | - | (43.8) | 1,101.8 | 1.85 | 1.78 | -4% | 724.8 | - | (52.6) | 672.2 | 1.18 | 1.10 | -7% |
| Comcast Corp | CMCSA | Dec-03 | | (218.0) | 10.0 | (172.0) | (380.0) | (0.10) | (0.18) | 74% | (469.0) | 11.0 | (145.0) | (603.0) | (0.42) | (0.54) | 28% |
| Dow Jones & Co. | DJ | Dec-03 | | 170.6 | 4.5 | (20.2) | 154.8 | 2.06 | 1.89 | -9% | 201.5 | 1.8 | (18.2) | 184.9 | 2.40 | 2.20 | -8% |
| Gannett Co. | GCI | Dec-03 | | 1,211.2 | - | (64.0) | 1,147.2 | 4.46 | 4.22 | -5% | 1,160.1 | - | (52.8) | 1,107.4 | 4.31 | 4.11 | -5% |
| Interpublic Group | IPG | Dec-03 | | (552.9) | 22.7 | (57.4) | (587.6) | (1.43) | (1.52) | 6% | 86.0 | 28.9 | (65.4) | 31.5 | 0.18 | 0.08 | -54% |
| Knight-Ridder Inc. | KRI | Dec-03 | | 296.1 | - | (14.6) | 281.4 | 3.63 | 3.45 | -5% | 281.7 | - | (15.0) | 266.7 | 3.33 | 3.15 | -5% |
| McGraw-Hill | MHP | Dec-03 | | 687.8 | 9.2 | (52.3) | 644.7 | 3.56 | 3.35 | -6% | 572.0 | 13.0 | (63.1) | 521.8 | 2.94 | 2.69 | -9% |
| Meredith Corp. | MDP | Jun-03 | | 91.1 | 0.5 | (6.9) | 84.7 | 1.78 | 1.66 | -7% | 91.4 | 0.8 | (6.5) | 85.7 | 1.79 | 1.67 | -6% |
| New York Times Cl. A | NYT | Dec-03 | | 302.7 | - | (48.4) | 254.3 | 1.98 | 1.68 | -16% | 299.7 | - | (49.9) | 250.8 | 1.94 | 1.63 | -16% |
| Omnicom Group | OMC | Dec-03 | Retroactive Restatement | 675.9 | 38.2 | (81.1) | 632.9 | 3.59 | 3.37 | -7% | 643.5 | 32.7 | (105.7) | 570.5 | 3.44 | 3.07 | -11% |
| Time Warner Inc. | TWX | Dec-03 | | 3,146.0 | - | (548.0) | 2,598.0 | 0.68 | 0.56 | -17% | (43,449.0) | - | (1,034.0) | (44,483.0) | (8.75) | (8.99) | 2% |
| Tribune Co. | TRB | Dec-03 | | 891.4 | - | (75.8) | 815.6 | 2.61 | 2.36 | -9% | 605.8 | - | (82.5) | 523.1 | 1.80 | 1.54 | -14% |
| Univision Communications | UVN | Dec-03 | | 156.4 | - | (32.1) | 123.3 | 0.56 | 0.43 | -21% | 86.5 | - | (35.5) | 51.0 | 0.34 | 0.20 | -41% |
| Viacom Inc. | VIA.B | Dec-03 | | 1,435.4 | - | (252.3) | 1,183.1 | 0.82 | 0.68 | -18% | 2,296.6 | - | (290.3) | 2,006.3 | 1.24 | 1.13 | -9% |
| Walt Disney Co. | DIS | Sep-03 | | 1,338.0 | - | (294.0) | 1,044.0 | 0.65 | 0.51 | -22% | 1,236.0 | - | (306.0) | 930.0 | 0.60 | 0.45 | -25% |
| **Total** | | | | **10,778.2** | **83.0** | **(1,783.7)** | **9,095.5** | | | **-16%** | **(35,737.9)** | **88.0** | **(2,234.6)** | **(37,884.3)** | | | **NM** |



BEAR, STEARNS & CO. INC. 383 MADISON AVENUE NEW YORK, NY 10179 (212) 272-2000 WWW.BEARSTEARNS.COM

APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR
STEARNS

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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Multiline Retail (11)*** | | | | | | | | | | | | | | | | | |
| Big Lots, Inc | BLI | Jan-04 | | 90.9 | - | (5.0) | 84.9 | 0.78 | 0.73 | -7% | 76.6 | - | (5.1) | 71.5 | 0.66 | 0.61 | -7% |
| Dillard Inc. | DDS | Jan-04 | | 9.3 | - | (2.7) | 6.6 | 0.11 | 0.08 | -29% | 131.9 | - | (9.3) | 122.7 | 1.55 | 1.44 | -7% |
| Dollar General | DG | Jan-04 | | 301.0 | - | (7.9) | 293.1 | 0.89 | 0.87 | -3% | 264.9 | - | (15.2) | 249.7 | 0.79 | 0.75 | -6% |
| Family Dollar Stores | FDO | Aug-03 | | 247.5 | - | (6.0) | 241.5 | 1.43 | 1.39 | -2% | 216.9 | - | (4.3) | 212.6 | 1.25 | 1.22 | -2% |
| Federated Dept. Stores | FD | Jan-04 | | 693.0 | - | (46.0) | 647.0 | 3.71 | 3.46 | -7% | 638.0 | - | (42.0) | 596.0 | 3.21 | 3.00 | -7% |
| Kohl's Corp. | KSS | Jan-04 | | 591.2 | - | (34.4) | 556.7 | 1.72 | 1.62 | -6% | 643.4 | - | (34.9) | 608.4 | 1.87 | 1.78 | -5% |
| May Dept. Stores | MAY | Jan-04 | Prospective | 434.0 | 2.0 | (22.0) | 414.0 | 1.41 | 1.34 | -5% | 542.0 | - | (23.0) | 519.0 | 1.76 | 1.69 | -4% |
| Nordstrom | JWN | Jan-04 | | 242.6 | 9.9 | (23.7) | 229.0 | 1.76 | 1.67 | -6% | 103.6 | 2.2 | (21.9) | 83.9 | 0.76 | 0.62 | -19% |
| Penney, J.C. | JCP | Jan-04 | | 364.0 | 5.0 | (26.0) | 343.0 | 1.21 | 1.14 | -6% | 285.0 | 3.0 | (23.0) | 265.0 | 0.95 | 0.89 | -7% |
| Sears, Roebuck & Co. | S | Dec-03 | | 3,397.0 | - | (44.0) | 3,353.0 | 11.86 | 11.71 | -1% | 1,584.0 | - | (49.0) | 1,535.0 | 4.94 | 4.79 | -3% |
| Target Corp. | TGT | Jan-04 | Prospective | 1,941.0 | 3.0 | (35.0) | 1,909.0 | 2.01 | 1.97 | -2% | 1,854.0 | - | (31.0) | 1,823.0 | 1.81 | 1.78 | -2% |
| **Total** | | | | **8,211.7** | **19.9** | **(253.8)** | **7,977.8** | | | **-3%** | **8,140.3** | **5.2** | **(258.7)** | **5,886.9** | | | **-4%** |
| ***Specialty Retail (17)*** | | | | | | | | | | | | | | | | | |
| AutoNation, Inc. | AN | Dec-03 | | 506.1 | - | (17.4) | 488.7 | 1.78 | 1.70 | -3% | 381.6 | - | (19.3) | 362.3 | 1.19 | 1.13 | -5% |
| AutoZone Inc | AZO | Aug-03 | | 517.8 | - | (14.5) | 503.1 | 5.34 | 5.20 | -3% | 428.1 | - | (9.0) | 419.2 | 4.00 | 3.91 | -2% |
| Bed Bath & Beyond | BBBY | Feb-03 | | 302.2 | - | (25.4) | 276.7 | 1.00 | 0.92 | -8% | 219.6 | - | (19.6) | 200.0 | 0.74 | 0.67 | -9% |
| Best Buy Co., Inc | BBY | Feb-03 | | 622.0 | 1.0 | (85.0) | 538.0 | 1.91 | 1.66 | -14% | 570.0 | 1.0 | (58.0) | 512.0 | 1.77 | 1.61 | -10% |
| Boise Cascade | BCC | Dec-03 | Prospective | 17.1 | 4.2 | (8.3) | 12.0 | 0.07 | (0.01) | -30% | 11.3 | 0.2 | (10.7) | 0.8 | (0.03) | (0.21) | -93% |
| Circuit City Group | CC | Feb-03 | | 41.8 | - | (16.6) | 24.0 | 0.20 | 0.12 | -40% | 128.0 | - | (16.5) | 111.5 | 0.62 | 0.54 | -13% |
| Gap (The) | GPS | Jan-04 | | 1,030.0 | 1.0 | (53.0) | 978.0 | 1.09 | 1.03 | -5% | 477.0 | 4.0 | (42.0) | 439.0 | 0.54 | 0.50 | -8% |
| Home Depot | HD | Jan-04 | Prospective | 4,304.0 | 42.0 | (279.0) | 4,067.0 | 1.88 | 1.78 | -6% | 3,664.0 | 10.0 | (260.0) | 3,414.0 | 1.56 | 1.46 | -7% |
| Limited Brands, Inc. | LTD | Jan-04 | | 717.0 | 12.0 | (38.0) | 691.0 | 1.36 | 1.32 | -4% | 456.0 | 58.0 | (50.0) | 504.0 | 0.95 | 0.89 | 2% |
| Lowe's Cos. | LOW | Jan-04 | Prospective | 1,882.0 | - | (61.0) | 1,801.0 | 2.32 | 2.25 | -3% | 1,459.0 | - | (85.0) | 1,374.0 | 1.83 | 1.71 | -6% |
| Office Depot | ODP | Dec-03 | | 302.0 | - | (22.4) | 279.6 | 0.96 | 0.89 | -7% | 311.5 | - | (29.4) | 282.1 | 0.98 | 0.89 | -9% |
| RadioShack Corp | RSH | Dec-03 | | 296.5 | 14.2 | (61.1) | 261.6 | 1.77 | 1.55 | -12% | 293.4 | 14.0 | (80.5) | 216.9 | 1.45 | 1.19 | -18% |
| Sherwin-Williams | SHW | Dec-03 | | 332.1 | 3.7 | (12.1) | 323.8 | 2.26 | 2.20 | -3% | 310.7 | 2.0 | (11.5) | 301.3 | 2.94 | 1.88 | -3% |
| Staples Inc. | SPLS | Jan-04 | | 490.2 | - | (40.0) | 450.2 | 0.99 | 0.91 | -8% | 446.1 | - | (33.3) | 412.8 | 0.94 | 0.87 | -7% |
| Tiffany & Co. | TIF | Jan-04 | | 215.5 | - | (13.2) | 202.3 | 1.45 | 1.36 | -6% | 189.9 | - | (12.8) | 177.1 | 1.28 | 1.19 | -7% |
| TJX Companies Inc. | TJX | Jan-04 | | 656.4 | 6.3 | (55.2) | 609.4 | 1.28 | 1.19 | -7% | 576.4 | 2.0 | (41.7) | 538.7 | 1.08 | 1.00 | -7% |
| Toys R Us, Inc. | TOY | Jan-04 | | 88.0 | - | (34.0) | 54.0 | 0.41 | 0.25 | -39% | 229.0 | - | (39.0) | 190.0 | 1.09 | 0.91 | -17% |
| **Total** | | | | **12,364.2** | **94.4** | **(627.4)** | **11,561.2** | | | **-6%** | **10,183.8** | **91.1** | **(799.2)** | **9,485.5** | | | **-7%** |
| ***Textiles, Apparel & Luxury Goods (5)*** | | | | | | | | | | | | | | | | | |
| Jones Apparel Group | JNY | Dec-03 | Prospective | 326.6 | 7.5 | (19.5) | 316.6 | 2.48 | 2.39 | -4% | 332.3 | 8.0 | (37.7) | 302.6 | 2.46 | 2.24 | -9% |
| Liz Claiborne, Inc. | LIZ | Dec-03 | | 279.7 | - | (19.9) | 259.7 | 2.55 | 2.39 | -7% | 231.2 | - | (16.8) | 214.4 | 2.16 | 2.02 | -7% |
| NIKE Inc. | NKE | May-03 | | 740.1 | - | (42.2) | 697.9 | 2.77 | 2.62 | -6% | 668.3 | - | (36.1) | 632.2 | 2.46 | 2.32 | -5% |
| Reebok International | RBK | Dec-03 | | 157.3 | - | (10.4) | 146.8 | 2.43 | 2.32 | -7% | 131.5 | - | (7.0) | 124.5 | 2.04 | 1.98 | -5% |
| V.F. Corp. | VFC | Dec-03 | | 397.9 | 1.0 | (13.6) | 385.3 | 3.61 | 3.48 | -3% | 364.4 | 0.6 | (15.5) | 349.5 | 3.24 | 3.10 | -4% |
| **Total** | | | | **1,903.6** | **8.5** | **(105.7)** | **1,806.4** | | | **-5%** | **1,727.7** | **8.6** | **(113.1)** | **1,623.2** | | | **-6%** |
| ***Consumer Discretionary (57)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **47,867.7** | **546.2** | **(4,335.0)** | **44,078.8** | | | **-8%** | **(4,635.6)** | **285.1** | **(5,017.5)** | **(9,368.0)** | | | **N/M** |
| ***Consumer Staples*** | | | | | | | | | | | | | | | | | |
| ***Beverages (7)*** | | | | | | | | | | | | | | | | | |
| Anheuser-Busch | BUD | Dec-03 | | 2,075.9 | - | (113.4) | 1,962.5 | 2.48 | 2.34 | -5% | 1,933.8 | - | (93.1) | 1,840.7 | 2.20 | 2.09 | -5% |
| Brown-Forman Corp. | BF.B | Apr-03 | | 245.0 | - | (4.0) | 241.0 | 3.63 | 3.57 | -2% | 228.0 | - | (4.0) | 224.0 | 3.33 | 3.27 | -2% |
| Coca Cola Co. | KO | Dec-03 | Modified Prospective | 4,347.0 | 336.0 | (336.0) | 4,347.0 | 1.77 | 1.77 | 0% | 3,976.0 | 267.0 | (267.0) | 3,976.0 | 1.60 | 1.60 | 0% |
| Coca-Cola Enterprises | CCE | Dec-03 | | 678.0 | 8.0 | (69.0) | 615.0 | 1.46 | 1.33 | -9% | 494.0 | 5.0 | (52.0) | 447.0 | 1.07 | 0.97 | -10% |
| Coors (Adolph) | RKY | Dec-03 | | 174.7 | - | (10.3) | 164.3 | 4.77 | 4.48 | -6% | 161.7 | - | (12.1) | 149.6 | 4.42 | 4.09 | -7% |
| Pepsi Bottling Group | PBG | Dec-03 | | 422.0 | 2.0 | (42.0) | 382.0 | 1.52 | 1.37 | -9% | 428.0 | - | (40.0) | 388.0 | 1.46 | 1.32 | -9% |
| PepsiCo Inc. | PEP | Dec-03 | Retroactive Restatement | 3,568.0 | 293.0 | (293.0) | 3,568.0 | 2.05 | 2.05 | 0% | 3,000.0 | 313.0 | (313.0) | 3,000.0 | 1.68 | 1.68 | 0% |
| **Total** | | | | **11,508.6** | **611.0** | **(839.7)** | **11,279.8** | | | **-2%** | **10,221.5** | **585.0** | **(781.2)** | **10,025.3** | | | **-2%** |
| ***Food & Staples Retailing (10)*** | | | | | | | | | | | | | | | | | |
| Albertson's | ABS | Jan-04 | | 556.0 | 16.0 | (45.0) | 527.0 | 1.51 | 1.43 | -5% | 865.0 | 12.0 | (44.0) | 833.0 | 2.17 | 2.09 | -4% |
| Costco Co. | COST | Aug-03 | Prospective | 721.0 | 7.5 | (70.2) | 658.3 | 1.53 | 1.40 | -9% | 700.0 | - | (75.7) | 624.2 | 1.48 | 1.32 | -11% |
| CVS Corp. | CVS | Dec-03 | | 647.3 | - | (50.2) | 797.1 | 2.06 | 1.95 | -6% | 716.6 | - | (54.1) | 662.5 | 1.75 | 1.62 | -8% |
| Kroger Co. | KR | Jan-04 | | 319.0 | 8.0 | (48.0) | 275.0 | 0.42 | 0.36 | -13% | 1,221.0 | 6.0 | (47.0) | 1,160.0 | 1.54 | 1.49 | -3% |
| Safeway Inc. | SWY | Dec-03 | | (169.8) | - | (51.1) | (220.9) | (0.39) | (0.50) | 30% | (126.1) | - | (49.6) | (177.7) | (0.27) | (0.38) | 39% |
| Supervalu Inc | SVU | Feb-03 | | 257.0 | - | (9.5) | 247.5 | 1.91 | 1.84 | -4% | 198.3 | - | (5.5) | 192.8 | 1.48 | 1.44 | -3% |
| Sysco Corp. | SYY | Jun-03 | | 778.3 | - | (51.9) | 726.4 | 1.18 | 1.10 | -7% | 679.8 | - | (37.3) | 642.4 | 1.01 | 0.95 | -5% |
| Walgreen Co. | WAG | Aug-03 | | 1,175.7 | 0.7 | (57.0) | 1,119.4 | 1.14 | 1.09 | -5% | 1,019.2 | 8.9 | (67.3) | 958.8 | 0.99 | 0.93 | -6% |
| Wal-Mart Stores (c) | WMT | Jan-04 | Retroactive Restatement | 9,075.0 | 102.0 | (102.0) | 9,075.0 | 2.03 | 2.03 | 0% | 8,011.0 | 84.0 | (84.0) | 8,011.0 | 1.76 | 1.76 | 0% |
| Wrigley | WRM | Jun-03 | Prospective (g) | 239.2 | 5.4 | (5.4) | 239.2 | 1.70 | 1.70 | 0% | 187.2 | 4.5 | (4.5) | 187.2 | 1.33 | 0.62 | 0% |
| **Total** | | | | **13,794.8** | **139.6** | **(450.3)** | **13,444.9** | | | **-3%** | **13,470.0** | **113.4** | **(469.1)** | **13,114.3** | | | **-3%** |
| ***Food Products (15)*** | | | | | | | | | | | | | | | | | |
| Archer-Daniels-Midland | ADM | Jun-03 | | 451.1 | 2.7 | (8.1) | 445.7 | 0.70 | 0.69 | -1% | 511.1 | 0.5 | (6.0) | 505.5 | 0.78 | 0.77 | -1% |
| Campbell Soup | CPB | Jul-03 | | 626.0 | 13.0 | (37.0) | 602.0 | 1.52 | 1.46 | -4% | 525.0 | 19.0 | (34.0) | 510.0 | 1.28 | 1.24 | -3% |
| ConAgra Foods, Inc. | CAG | May-03 | | 840.1 | - | (20.2) | 819.9 | 1.58 | 1.55 | -2% | 735.1 | - | (17.6) | 717.5 | 1.38 | 1.35 | -2% |
| General Mills | GIS | May-03 | | 917.0 | 13.0 | (68.0) | 862.0 | 2.43 | 2.25 | -6% | 461.0 | 10.0 | (84.0) | 387.0 | 1.35 | 1.14 | -16% |
| Heinz (H.J.) | HNZ | Apr-03 | | 555.4 | - | (26.1) | 529.3 | 1.57 | 1.48 | -5% | 675.2 | - | (43.4) | 631.8 | 1.91 | 1.79 | -6% |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hershey Foods | HSY | Dec-03 | | 465.0 | - | (15.6) | 449.3 | 3.52 | 3.40 | -3% | 403.8 | - | (12.4) | 391.2 | 2.93 | 2.84 | -3% |
| Kellogg Co. | K | Dec-03 | | 787.1 | - | (29.6) | 757.5 | 1.92 | 1.83 | -4% | 720.9 | - | (42.1) | 678.8 | 1.75 | 1.65 | -6% |
| McCormick & Co. | MKC | Nov-03 | | 189.2 | 1.2 | (12.7) | 187.7 | 1.40 | 1.32 | -6% | 173.8 | - | (8.2) | 164.6 | 1.22 | 1.16 | -5% |
| Sara Lee Corp. | SLE | Jun-03 | | 1,221.0 | 16.0 | (49.0) | 1,188.0 | 1.50 | 1.46 | -3% | 1,010.0 | 24.0 | (80.0) | 954.0 | 1.23 | 1.17 | -5% |
| Wrigley (Wm) Jr. | WWY | Dec-03 | | 445.9 | 11.9 | (26.5) | 431.4 | 1.98 | 1.92 | -1% | 401.5 | 7.8 | (19.2) | 390.1 | 1.78 | 1.72 | -3% |
| **Total** | | | | **6,507.8** | **57.4** | **(292.8)** | **6,272.6** | | | **-4%** | **5,817.2** | **61.3** | **(347.9)** | **5,330.5** | | | **-5%** |
| ***Household Products (4)*** | | | | | | | | | | | | | | | | | |
| Clorox Co. | CLX | Jun-03 | | 514.0 | - | (21.0) | 493.0 | 2.33 | 2.24 | -4% | 357.0 | - | (26.0) | 331.0 | 1.52 | 1.41 | -7% |
| Colgate-Palmolive | CL | Dec-03 | | 1,421.3 | - | (44.2) | 1,377.1 | 2.46 | 2.38 | -3% | 1,268.3 | - | (39.5) | 1,248.8 | 2.19 | 2.12 | -3% |
| Kimberly-Clark | KMB | Dec-03 | | 1,694.2 | - | (55.6) | 1,638.6 | 3.33 | 3.22 | -3% | 1,686.0 | - | (70.2) | 1,615.8 | 3.24 | 3.11 | -4% |
| Procter & Gamble | PG | Jun-03 | | 5,186.0 | - | (398.0) | 4,788.0 | 3.69 | 3.41 | -8% | 4,352.0 | - | (442.0) | 3,910.0 | 3.09 | 2.77 | -10% |
| **Total** | | | | **8,815.5** | **-** | **(519.8)** | **8,296.7** | | | **-6%** | **7,663.3** | **-** | **(577.7)** | **7,105.6** | | | **-8%** |
| ***Personal Products (3)*** | | | | | | | | | | | | | | | | | |
| Alberto-Culver | ACV | Sep-03 | | 162.2 | 0.9 | (9.8) | 153.5 | 2.70 | 2.56 | -5% | 137.7 | 1.0 | (8.0) | 130.7 | 2.32 | 2.21 | -5% |
| Avon Products | AVP | Dec-03 | | 674.6 | - | (28.7) | 645.9 | 2.78 | 2.66 | -4% | 543.3 | - | (30.1) | 513.2 | 2.22 | 2.10 | -6% |
| Gillette Co. | G | Dec-03 | | 1,375.0 | - | (99.0) | 1,276.0 | 1.34 | 1.25 | -7% | 1,209.0 | - | (111.0) | 1,098.0 | 1.14 | 1.04 | -9% |
| **Total** | | | | **2,211.8** | **0.9** | **(137.3)** | **2,075.4** | | | **-6%** | **1,890.0** | **1.0** | **(149.1)** | **1,741.9** | | | **-8%** |
| ***Tobacco (3)*** | | | | | | | | | | | | | | | | | |
| Altria Group, Inc | MO | Dec-03 | | 9,609.0 | - | (19.0) | 9,590.0 | 4.52 | 4.51 | 0% | 11,674.0 | - | (137.0) | 11,537.0 | 5.21 | 5.15 | -1% |
| RJ Reynolds Tobacco | RJR | Dec-03 | Prospective | (3,689.0) | 10.0 | (9.0) | (3,688.0) | (44.06) | (44.07) | 0% | 418.0 | - | (8.0) | 410.0 | 4.94 | 4.55 | -2% |
| UST Inc. | UST | Dec-03 | | 318.8 | 0.1 | (3.9) | 315.0 | 1.90 | 1.88 | -1% | (271.5) | - | (4.4) | (275.9) | (1.61) | (1.63) | 2% |
| **Total** | | | | **6,238.8** | **10.1** | **(31.8)** | **6,217.0** | | | **0%** | **11,820.5** | **-** | **(149.4)** | **11,671.1** | | | **-1%** |
| ***Consumer Staples (37)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **49,077.1** | **819.5** | **(2,310.8)** | **47,585.7** | | | **-3%** | **50,702.4** | **760.7** | **(2,474.4)** | **48,988.7** | | | **-3%** |
| ***Energy*** | | | | | | | | | | | | | | | | | |
| ***Energy Equipment & Services (8)*** | | | | | | | | | | | | | | | | | |
| Baker Hughes | BHI | Dec-03 | | 180.1 | 1.9 | (23.1) | 158.9 | 0.54 | 0.48 | -12% | 229.6 | 2.1 | (23.3) | 208.4 | 0.66 | 0.62 | -6% |
| BJ Services | BJS | Sep-03 | | 186.2 | - | (15.4) | 172.8 | 1.17 | 1.07 | -8% | 166.5 | - | (17.0) | 149.5 | 1.04 | 0.93 | -10% |
| Halliburton Co. | HAL | Dec-03 | | 339.0 | - | (30.0) | 309.0 | 0.78 | 0.71 | -9% | (346.0) | - | (26.0) | (372.0) | (0.80) | (0.86) | 8% |
| Nabors Industries Ltd. | NBR | Dec-03 | | 192.2 | - | (13.6) | 178.7 | 1.25 | 1.16 | -7% | 121.5 | - | (31.0) | 90.4 | 0.81 | 0.60 | -26% |
| Noble Corporation | NE | Dec-03 | | 166.4 | 3.0 | (20.1) | 149.3 | 1.25 | 1.12 | -10% | 206.5 | 3.2 | (22.5) | 190.2 | 1.57 | 1.43 | -9% |
| Rowan Cos. | RDC | Dec-03 | | (7.8) | 4.6 | (9.0) | (12.2) | (0.08) | (0.13) | 56% | 86.3 | 4.7 | (8.8) | 82.3 | 0.90 | 0.86 | -5% |
| Schlumberger Ltd. | SLB | Dec-03 | Prospective | 472.6 | - | (91.0) | 381.6 | 0.81 | 0.65 | -19% | (2,417.2) | - | (156.0) | (2,573.2) | (4.18) | (4.45) | 6% |
| Transocean Inc. | RIG | Dec-03 | Prospective | 18.4 | 4.6 | (20.1) | 2.9 | 0.06 | 0.01 | -84% | (2,368.2) | 2.8 | (25.7) | (2,391.1) | (7.42) | (7.50) | 1% |
| **Total** | | | | **1,548.1** | **14.1** | **(222.3)** | **1,341.9** | | | **-13%** | **(4,318.9)** | **12.7** | **(310.1)** | **(4,615.4)** | | | **NM** |
| ***Oil & Gas (15)*** | | | | | | | | | | | | | | | | | |
| Amerada Hess | AHC | Dec-03 | | 467.0 | 7.0 | (8.0) | 466.0 | 5.17 | 5.17 | 0% | (245.0) | 5.0 | (19.0) | (259.0) | (2.75) | (2.93) | 6% |
| Anadarko Petroleum | APC | Dec-03 | Prospective | 1,245.0 | 12.0 | (30.0) | 1,227.0 | 4.91 | 4.84 | -1% | 831.0 | 9.0 | (32.0) | 808.0 | 3.21 | 3.13 | -3% |
| Apache Corp. | APA | Dec-03 | Prospective | 1,096.3 | 2.5 | (23.0) | 1,074.8 | 3.35 | 3.29 | -2% | 554.3 | 1.1 | (20.8) | 534.6 | 1.86 | 1.72 | -4% |
| Ashland Inc. | ASH | Sep-03 | Modified Prospective | 94.0 | 5.0 | (5.0) | 94.0 | 1.37 | 1.37 | 0% | 115.0 | - | (4.0) | 111.0 | 1.64 | 1.58 | -3% |
| Burlington Resources | BR | Dec-03 | | 1,260.0 | - | (10.0) | 1,250.0 | 6.30 | 6.25 | -1% | 454.0 | - | (11.0) | 443.0 | 2.25 | 2.20 | -2% |
| ChevronTexaco Corp. | CVX | Dec-03 | | 7,426.0 | 1.0 | (26.0) | 7,401.0 | 7.14 | 7.11 | 0% | 1,132.0 | (1.0) | (48.0) | 1,083.0 | 1.07 | 1.02 | -4% |
| ConocoPhillips | COP | Dec-03 | Prospective | 4,553.0 | 50.0 | (78.0) | 4,525.0 | 6.70 | 6.66 | -1% | 596.0 | 74.0 | (135.0) | 637.0 | 1.44 | 1.32 | -8% |
| Devon Energy Corp. | DVN | Dec-03 | | 1,731.0 | 2.0 | (23.0) | 1,710.0 | 8.00 | 7.91 | -1% | 59.0 | 1.0 | (17.0) | 43.0 | 0.32 | 0.23 | -27% |
| EOG Resources | EOG | Dec-03 | | 437.3 | - | (13.9) | 423.4 | 3.66 | 3.54 | -3% | 87.2 | - | (13.7) | 73.5 | 0.85 | 0.53 | -16% |
| Exxon Mobil Corp. | XOM | Dec-03 | Prospective | 20,960.0 | 86.0 | (93.0) | 20,953.0 | 3.15 | 3.15 | 0% | 11,011.0 | 19.0 | (180.0) | 10,850.0 | 1.61 | 1.59 | -1% |
| Kerr-McGee | KMG | Dec-03 | | 254.0 | - | (18.0) | 236.0 | 2.48 | 2.34 | -6% | (511.0) | - | (15.0) | (526.0) | (6.06) | (6.24) | 7% |
| Marathon Oil Corp. | MRO | Dec-03 | Prospective | 1,012.0 | 23.0 | (17.0) | 1,018.0 | 3.26 | 3.28 | 1% | 507.0 | 5.0 | (16.0) | 496.0 | 1.63 | 1.60 | -2% |
| Occidental Petroleum | OXY | Dec-03 | | 1,585.0 | 38.0 | (58.0) | 1,577.0 | 4.11 | 4.06 | -1% | 1,163.0 | 18.0 | (37.0) | 1,144.0 | 3.07 | 3.01 | -2% |
| Sunoco, Inc. | SUN | Dec-03 | Modified Prospective | 312.0 | 13.0 | (13.0) | 312.0 | 4.03 | 4.03 | 0% | (47.0) | 11.0 | (11.0) | (47.0) | (0.62) | (0.62) | 0% |
| Unocal Corp. | UCL | Dec-03 | Prospective | 710.0 | 17.0 | (22.0) | 705.0 | 2.70 | 2.68 | -1% | 320.0 | 26.0 | (36.0) | 309.0 | 1.34 | 1.21 | -9% |
| **Total** | | | | **43,191.5** | **256.5** | **(473.0)** | **43,914.2** | | | **0%** | **16,038.5** | **186.1** | **(815.5)** | **15,591.1** | | | **-3%** |
| ***Energy (23)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **44,740.6** | **270.7** | **(695.1)** | **44,355.2** | | | **-1%** | **11,720.5** | **198.8** | **(925.6)** | **10,975.7** | | | **-6%** |
| ***Financials*** | | | | | | | | | | | | | | | | | |
| ***Capital Markets (15)*** | | | | | | | | | | | | | | | | | |
| Bank of New York | BK | Dec-03 | Prospective | 1,157.0 | 18.0 | (81.0) | 1,092.0 | 1.52 | 1.45 | -6% | 902.0 | - | (87.0) | 815.0 | 1.24 | 1.13 | -10% |
| Bear Stearns Cos. | BSC | Nov-03 | Prospective | 1,156.1 | 306.4 | (358.5) | 1,103.3 | 8.82 | 8.18 | -5% | 878.3 | 216.7 | (263.0) | 832.0 | 6.47 | 6.15 | -5% |
| Charles Schwab | SCH | Dec-03 | | 472.0 | 6.0 | (112.0) | 366.0 | 0.35 | 0.27 | -22% | 135.0 | 6.0 | (154.0) | (13.0) | 0.10 | (0.01) | -110% |
| Federated Investors Inc. | FII | Dec-03 | Prospective | 191.5 | 0.2 | (4.7) | 187.0 | 1.71 | 1.67 | -2% | 203.6 | 0.0 | (6.9) | 196.9 | 1.74 | 1.68 | -3% |
| Franklin Resources | BEN | Sep-03 | | 502.8 | - | (65.3) | 437.5 | 1.97 | 1.72 | -13% | 432.7 | - | (59.3) | 373.4 | 1.65 | 1.42 | -14% |
| Goldman Sachs Group | GS | Nov-03 | Prospective | 3,005.0 | 458.0 | (782.0) | 2,681.0 | 5.87 | 5.24 | -11% | 2,114.0 | 416.0 | (785.0) | 1,745.0 | 4.03 | 3.32 | -17% |
| J.P. Morgan Chase & Co. | JPM | Dec-03 | Prospective | 6,319.0 | 551.0 | (863.0) | 6,407.0 | 3.24 | 3.09 | -5% | 1,669.0 | 394.0 | (1,232.0) | 786.0 | 0.80 | 0.37 | -53% |
| Janus Capital Group | JNS | Dec-03 | | 955.8 | 48.5 | (55.7) | 948.6 | 4.17 | 4.14 | -1% | 94.5 | 76.0 | (83.4) | 87.1 | 0.43 | 0.40 | -6% |
| Lehman Bros. | LEH | Nov-03 | Prospective | 1,699.0 | 362.0 | (534.0) | 1,527.0 | 6.35 | 5.77 | -10% | 975.0 | 330.0 | (475.0) | 830.0 | 3.47 | 2.95 | -15% |
| Mellon Bank Corp. | MEL | Dec-03 | Prospective | 677.0 | 18.0 | (52.0) | 643.0 | 1.57 | 1.49 | -5% | 883.0 | 16.0 | (56.0) | 823.0 | 1.51 | 1.42 | -6% |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included In Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included In Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Merrill Lynch | MER | Dec-03 | Retroactive Restatement | 3,988.0 | 484.0 | (638.0) | 3,834.0 | 4.05 | 3.89 | -4% | 2,513.0 | 527.0 | (1,331.0) | 1,709.0 | 2.63 | 1.77 | -32% |
| Morgan Stanley | MWO | Nov-03 | Prospective | 3,787.0 | 117.0 | (117.0) | 3,787.0 | 3.45 | 3.45 | 0% | 2,988.0 | - | (250.0) | 2,738.0 | 2.69 | 2.45 | -8% |
| Northern Trust Corp. | NTRS | Dec-03 | | 423.3 | 12.7 | (59.3) | 376.7 | 1.89 | 1.68 | -11% | 447.1 | 16.2 | (70.3) | 393.0 | 1.97 | 1.73 | -12% |
| State Street Corp. | STT | Dec-03 | Prospective | 722.0 | 22.0 | (61.0) | 683.0 | 2.15 | 2.04 | -5% | 1,016.0 | - | (49.0) | 966.0 | 3.10 | 2.95 | -5% |
| T. Rowe Price Group | TROW | Dec-03 | - | 227.5 | - | (26.6) | 201.7 | 1.77 | 1.59 | -11% | 194.3 | - | (27.4) | 166.9 | 1.52 | 1.31 | -14% |
| **Total** | | | | 25,683.3 | 2,401.8 | (3,810.3) | 24,274.8 | | | -5% | 15,218.7 | 1,957.9 | (4,929.3) | 12,247.3 | | | -20% |
| ***Commercial Banks (25)*** | | | | | | | | | | | | | | | | | |
| AmSouth Bancorporation | ASO | Dec-03 | | 626.1 | 1.9 | (27.0) | 601.0 | 1.77 | 1.70 | -4% | 609.1 | 2.1 | (26.6) | 584.6 | 1.68 | 1.62 | -4% |
| Bank of America Corp. | BAC | Dec-03 | Prospective | 10,810.0 | 78.0 | (225.0) | 10,663.0 | 7.13 | 7.05 | -1% | 9,249.0 | - | (413.0) | 8,836.0 | 5.91 | 5.64 | -4% |
| Bank One Corp. | ONE | Dec-03 | Prospective | 3,125.0 | 115.0 | (147.0) | 3,093.0 | 2.75 | 2.73 | -1% | 3,256.0 | 75.0 | (138.0) | 3,193.0 | 2.77 | 2.73 | -2% |
| BB&T Corporation | BBT | Dec-03 | | 1,064.9 | 0.6 | (29.0) | 1,036.5 | 2.07 | 2.02 | -3% | 1,293.2 | 1.6 | (31.5) | 1,263.3 | 2.70 | 2.64 | -2% |
| Charter One Financial | CF | Dec-03 | | 630.9 | - | (30.1) | 600.8 | 2.74 | 2.61 | -5% | 577.7 | - | (28.4) | 549.3 | 2.45 | 2.33 | -5% |
| Comerica Inc. | CMA | Dec-03 | Prospective | 661.0 | 18.0 | (26.0) | 653.0 | 3.75 | 3.70 | -1% | 601.0 | 17.0 | (30.0) | 588.0 | 3.40 | 3.32 | -2% |
| Fifth Third Bancorp | FITB | Dec-03 | Retroactive Restatement | 1,742.0 | - | (90.0) | 1,652.0 | 2.97 | 2.81 | -5% | 1,668.0 | - | (103.0) | 1,564.0 | 2.75 | 2.57 | -6% |
| First Tennessee National | FTN | Dec-03 | | 473.3 | 6.4 | (27.1) | 452.6 | 3.62 | 3.46 | -4% | 376.5 | 7.5 | (22.1) | 361.9 | 2.88 | 2.76 | -4% |
| Fleet Boston Financial Group | FBF | Dec-03 | Prospective | 2,556.0 | 46.0 | (103.0) | 2,499.0 | 2.41 | 2.35 | -2% | 1,524.0 | 37.0 | (134.0) | 1,427.0 | 1.44 | 1.34 | -6% |
| Huntington Bancshares | HBAN | Dec-03 | - | 385.7 | - | (12.7) | 373.0 | 1.67 | 1.61 | -3% | 323.7 | - | (12.7) | 311.0 | 1.33 | 1.27 | -4% |
| KeyCorp | KEY | Dec-03 | Prospective | 903.0 | 15.0 | (26.0) | 892.0 | 2.12 | 2.10 | -1% | 976.0 | 5.0 | (28.0) | 953.0 | 2.27 | 2.23 | -2% |
| M&T Bank Corp. | MTB | Dec-03 | Retroactive Restatement | 573.9 | 32.0 | (32.0) | 573.9 | 4.95 | 4.85 | 0% | 456.8 | 28.0 | (28.0) | 456.8 | 4.78 | 4.78 | 0% |
| Marshall & Ilsley Corp. | MI | Dec-03 | - | 544.1 | - | (22.3) | 521.8 | 2.38 | 2.29 | -4% | 480.3 | - | (22.1) | 458.2 | 2.16 | 2.07 | -5% |
| National City Corp. | NCC | Dec-03 | Prospective | 2,117.1 | 8.7 | (46.6) | 2,079.1 | 3.43 | 3.37 | -2% | 1,446.6 | - | (51.1) | 1,395.5 | 2.35 | 2.26 | -4% |
| North Fork Bancorporation | NFB | Dec-03 | | 396.4 | 6.8 | (9.3) | 393.9 | 2.60 | 2.56 | -1% | 416.9 | 5.5 | (11.7) | 410.7 | 2.54 | 2.54 | 0% |
| PNC Bank Corp | PNC | Dec-03 | Prospective | 1,029.0 | 21.0 | (54.0) | 996.0 | 3.65 | 3.53 | -3% | 1,200.0 | - | (47.0) | 1,153.0 | 4.30 | 4.04 | -4% |
| Regions Financial Corp. | RF | Dec-03 | | 651.6 | - | (9.3) | 642.6 | 2.90 | 2.85 | -1% | 619.9 | - | (13.9) | 606.0 | 2.72 | 2.66 | -2% |
| SouthTrust Corp. | SOTR | Dec-03 | | 705.2 | - | (19.5) | 694.7 | 2.06 | 2.03 | -1% | 649.9 | - | (9.3) | 640.6 | 1.85 | 1.83 | -1% |
| SunTrust Banks | STI | Dec-03 | Prospective | 1,332.3 | 5.3 | (14.5) | 1,323.1 | 4.73 | 4.70 | -1% | 1,331.8 | 0.5 | (19.3) | 1,313.0 | 4.66 | 4.59 | -1% |
| Synovus Financial | SNV | Dec-03 | | 388.9 | - | (13.8) | 375.1 | 1.28 | 1.22 | -4% | 365.3 | - | (14.4) | 350.9 | 1.21 | 1.17 | -4% |
| U.S. Bancorp | USB | Dec-03 | Retroactive Restatement | 3,710.1 | 123.4 | (123.4) | 3,710.1 | 1.92 | 1.92 | 0% | 3,226.0 | 113.3 | (113.3) | 3,226.0 | 1.68 | 1.68 | 0% |
| Union Planters Corporation | UPC | Dec-03 | | 498.1 | - | (14.6) | 483.5 | 2.62 | 2.45 | -3% | 529.0 | - | (13.9) | 515.1 | 2.59 | 2.52 | -3% |
| Wachovia Corp | WB | Dec-03 | Prospective | 4,247.0 | 66.0 | (133.0) | 4,180.0 | 3.17 | 3.12 | -2% | 3,579.0 | 38.0 | (106.0) | 3,511.0 | 2.60 | 2.55 | -2% |
| Wells Fargo | WFC | Dec-03 | | 6,202.0 | 3.0 | (198.0) | 6,007.0 | 3.65 | 3.53 | -3% | 5,710.0 | 3.0 | (190.0) | 5,523.0 | 3.32 | 3.21 | -3% |
| Zions Bancorp | ZION | Dec-03 | | 339.8 | - | (15.4) | 324.2 | 3.74 | 3.57 | -5% | 317.1 | - | (17.2) | 299.9 | 3.44 | 3.26 | -5% |
| **Total** | | | | 45,712.4 | 547.1 | (1,439.6) | 44,819.9 | | | -2% | 40,763.5 | 333.8 | (1,828.7) | 39,492.7 | | | -3% |
| ***Consumer Finance (5)*** | | | | | | | | | | | | | | | | | |
| American Express | AXP | Dec-03 | Prospective | 3,000.0 | 79.0 | (349.0) | 2,730.0 | 2.31 | 2.10 | -9% | 2,871.0 | 26.0 | (355.0) | 2,342.0 | 2.01 | 1.76 | -12% |
| Capital One Financial | COF | Dec-03 | Prospective | 1,150.9 | 31.8 | (173.7) | 1,009.0 | 4.92 | 4.40 | -12% | 899.6 | 17.2 | (174.4) | 742.4 | 3.93 | 3.37 | -17% |
| MBNA Corp | KRB | Dec-03 | | 2,338.1 | 58.3 | (130.2) | 2,264.2 | 1.79 | 1.74 | -3% | 1,796.0 | 58.7 | (134.1) | 1,691.5 | 1.34 | 1.29 | -4% |
| Providian Financial Corp. | PVN | Dec-03 | | 196.2 | 4.9 | (28.3) | 172.8 | 0.67 | 0.59 | -12% | 151.0 | 7.2 | (47.2) | 111.0 | 0.52 | 0.39 | -26% |
| SLM Corporation | SLM | Dec-03 | | 1,403.6 | - | (85.5) | 1,318.1 | 3.01 | 2.82 | -6% | 792.0 | - | (104.1) | 687.9 | 1.64 | 1.43 | -13% |
| **Total** | | | | 8,088.8 | 172.0 | (766.7) | 7,494.1 | | | -7% | 6,279.6 | 110.2 | (814.8) | 5,574.8 | | | -11% |
| ***Diversified Financial Services (3)*** | | | | | | | | | | | | | | | | | |
| Citigroup Inc. | C | Dec-03 | Prospective | 17,853.0 | 110.0 | (365.0) | 17,598.0 | 3.42 | 3.37 | -1% | 13,448.0 | - | (434.0) | 13,014.0 | 2.59 | 2.51 | -3% |
| Moody's Corp | MCO | Dec-03 | Prospective | 363.9 | 6.6 | (20.0) | 350.5 | 2.39 | 2.30 | -4% | 288.9 | 0.1 | (14.3) | 274.7 | 1.83 | 1.75 | -5% |
| Principal Financial Group | PFG | Dec-03 | Prospective | 727.9 | 20.1 | (23.4) | 724.6 | 2.23 | 2.22 | 0% | 619.9 | 11.8 | (15.1) | 616.6 | 1.77 | 1.76 | -1% |
| **Total** | | | | 18,944.8 | 136.7 | (408.4) | 18,673.1 | | | -1% | 14,356.8 | 11.9 | (463.4) | 13,905.3 | | | -3% |
| ***Insurance (24)*** | | | | | | | | | | | | | | | | | |
| ACE Limited | ACE | Dec-03 | | 1,417.5 | 31.5 | (84.1) | 1,365.0 | 5.01 | 4.90 | -2% | 76.5 | 22.6 | (56.2) | 42.9 | 0.19 | 0.06 | -44% |
| AFLAC Corporation | AFL | Dec-03 | | 785.0 | - | (27.0) | 758.0 | 1.52 | 1.47 | -3% | 821.0 | - | (36.0) | 785.0 | 1.55 | 1.48 | -4% |
| Allstate Corp. | ALL | Dec-03 | Prospective | 2,725.0 | 9.0 | (40.0) | 2,694.0 | 3.85 | 3.81 | -1% | 1,475.0 | - | (40.0) | 1,435.0 | 2.07 | 2.01 | -3% |
| Ambac Financial Group | ABK | Dec-03 | Prospective | 628.1 | 4.5 | (15.5) | 617.1 | 5.74 | 5.64 | -2% | 431.9 | - | (12.6) | 419.3 | 3.96 | 3.84 | -3% |
| American Int'l. Group | AIG | Dec-03 | Prospective | 9,644.0 | 16.0 | (72.0) | 9,588.0 | 3.53 | 3.51 | -1% | 5,814.0 | - | (55.0) | 5,759.0 | 2.10 | 2.07 | -1% |
| Aon Corp. | AOC | Dec-03 | | 633.0 | 31.0 | (55.0) | 609.0 | 2.08 | 2.00 | -4% | 469.0 | 14.0 | (37.0) | 463.0 | 1.71 | 1.63 | -5% |
| Chubb Corp. | CB | Dec-03 | Modified Prospective | 808.8 | 59.1 | (59.1) | 808.8 | 4.46 | 4.46 | 0% | 222.9 | 14.5 | (69.0) | 168.4 | 1.29 | 0.97 | -24% |
| Cincinnati Financial | CINF | Dec-03 | | 374.0 | - | (10.0) | 364.0 | 2.31 | 2.25 | -3% | 238.0 | - | (10.0) | 228.0 | 1.46 | 1.40 | -4% |
| Hartford Financial Svc.Gp. | HIG | Dec-03 | Prospective | (91.0) | 20.0 | (50.0) | (121.0) | (0.33) | (0.44) | 33% | 1,000.0 | 6.0 | (59.0) | 947.0 | 3.97 | 3.76 | -5% |
| JeffersonPilot | JP | Dec-03 | | 492.0 | - | (6.0) | 486.0 | 3.44 | 3.40 | -1% | 450.0 | - | (11.0) | 439.0 | 3.04 | 2.96 | -3% |
| John Hancock Financial | JHF | Dec-03 | Prospective | 972.2 | 14.4 | (42.3) | 944.3 | 3.37 | 3.27 | -3% | 489.5 | 3.5 | (60.2) | 442.8 | 1.70 | 1.51 | -11% |
| Lincoln National (c) | LNC | Dec-03 | Retroactive Restatement | 767.2 | 35.6 | (35.6) | 767.2 | 4.27 | 4.27 | 0% | 48.6 | 36.1 | (36.1) | 48.6 | 0.26 | 0.26 | 0% |
| Loews Corp. | LTR | Dec-03 | - | (781.3) | - | (5.5) | (786.8) | (4.21) | (4.24) | -1% | 837.9 | - | (3.8) | 834.1 | 4.46 | 4.44 | 0% |
| Marsh & McLennan | MMC | Dec-03 | - | 1,540.0 | - | (171.0) | 1,369.0 | 2.81 | 2.50 | -11% | 1,365.0 | - | (152.0) | 1,213.0 | 2.45 | 2.18 | -11% |
| MBIA Inc. | MBI | Dec-03 | Modified Prospective | 813.8 | 8.0 | (8.0) | 813.8 | 5.61 | 5.61 | 0% | 586.8 | 7.2 | (7.2) | 586.8 | 3.98 | 3.98 | 0% |
| MetLife Inc | MET | Dec-03 | Prospective | 1,943.0 | 13.0 | (42.0) | 1,914.0 | 2.57 | 2.53 | -1% | 1,134.0 | 1.0 | (33.0) | 1,102.0 | 1.56 | 1.51 | -3% |
| Progressive Corp. | PGR | Dec-03 | Prospective | 1,255.4 | - | (12.8) | 1,242.6 | 5.69 | 5.65 | -1% | 667.3 | - | (16.9) | 650.4 | 2.99 | 2.92 | -3% |
| Prudential Financial | PRU | Dec-03 | Prospective | 1,069.0 | 10.0 | (45.0) | 1,034.0 | 2.08 | 1.99 | -3% | 754.0 | - | (30.0) | 724.0 | 1.38 | 1.33 | -4% |
| SAFECO Corp | SAFC | Dec-03 | Prospective | 339.2 | 5.7 | (13.5) | 331.4 | 2.44 | 2.39 | -2% | 301.1 | - | (14.0) | 287.1 | 2.33 | 2.22 | -5% |
| St. Paul Cos. | SPC | Dec-03 | | 699.0 | - | (39.0) | 660.0 | 2.88 | 2.75 | -6% | 249.0 | - | (37.0) | 212.0 | 1.06 | 0.91 | -15% |
| Torchmark Corp. | TMK | Dec-03 | | 430.1 | 0.4 | (8.1) | 422.4 | 3.73 | 3.67 | -2% | 383.4 | 0.5 | (8.2) | 375.7 | 3.18 | 3.12 | -2% |
| Travelers Property Casualty Corp. | TAP.B | Dec-03 | Prospective | 1,696.0 | 18.2 | (73.2) | 1,641.0 | 1.68 | 1.63 | -3% | 215.6 | 17.0 | (96.1) | 136.5 | 0.23 | 0.15 | -37% |
| UnumProvident Corp. | UNM | Dec-03 | | (264.6) | 0.6 | (12.8) | (276.8) | (0.96) | (1.00) | 5% | 396.8 | - | (15.5) | 381.4 | 1.83 | 1.57 | -4% |
| XL Capital | XL | Dec-03 | Prospective | 412.0 | 5.6 | (49.5) | 368.1 | 2.69 | 2.37 | -11% | 405.6 | - | (54.3) | 351.2 | 2.88 | 2.49 | -13% |
| **Total** | | | | 28,317.1 | 282.8 | (956.9) | 27,642.8 | | | -2% | 18,860.3 | 122.3 | (652.1) | 18,032.6 | | | -4% |



BEAR, STEARNS & CO. INC. 383 MADISON AVENUE NEW YORK, NY 10179 (212) 272-2000 WWW.BEARSTEARNS.COM

APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Real Estate (6)*** | | | | | | | | | | | | | | | | | |
| Apartment Investment & Mgmt'A' | AIV | Dec-03 | Prospective | 70.7 | 5.8 | (12.2) | 64.3 | (0.25) | (0.32) | -9% | 160.0 | 5.4 | (13.0) | 152.4 | 0.77 | 0.68 | -5% |
| Equity Office Properties | EOP | Dec-03 | Prospective | 549.1 | 3.8 | (10.9) | 542.0 | 1.26 | 1.24 | -1% | 670.9 | 2.5 | (12.1) | 661.3 | 1.49 | 1.47 | -1% |
| Equity Residential | EQR | Dec-03 | Prospective | 211.6 | 14.9 | (19.0) | 207.4 | 0.43 | 0.42 | -2% | 248.8 | 25.8 | (33.5) | 238.2 | 0.59 | 0.56 | -3% |
| Plum Creek Timber Co. | PCL | Dec-03 | Prospective | 192.0 | 4.0 | (4.0) | 192.0 | 1.04 | 1.04 | 0% | 233.0 | 5.0 | (5.0) | 233.0 | 1.26 | 1.28 | 0% |
| Prologis | PLD | Dec-03 | | 250.7 | - | (4.1) | 246.5 | 1.16 | 1.14 | -2% | 246.9 | - | (5.8) | 243.1 | 1.20 | 1.17 | -2% |
| Simon Property Group, Inc (f) | SPG | Dec-03 | Prospective | 449.9 | 6.2 | (6.2) | 449.9 | 1.53 | 1.53 | 0% | 541.6 | 5.4 | (5.4) | 541.6 | 1.92 | 1.92 | 0% |
| **Total** | | | | **1,724.0** | **34.7** | **(56.5)** | **1,702.2** | | | **-1%** | **2,101.2** | **44.1** | **(74.7)** | **2,076.6** | | | **-1%** |
| ***Thrifts & Mortgage Finance (8)*** | | | | | | | | | | | | | | | | | |
| Countrywide Financial Corp. | CFC | Dec-03 | | 2,373.0 | - | (28.2) | 2,344.8 | 12.47 | 12.32 | -1% | 841.8 | - | (25.9) | 815.8 | 4.87 | 4.72 | -3% |
| Fannie Mae | FNM | Dec-03 | Prospective | 7,720.0 | 64.0 | (116.0) | 7,668.0 | 7.72 | 7.66 | -1% | 4,819.0 | 25.0 | (105.0) | 4,539.0 | 4.52 | 4.44 | -2% |
| Federal Home Loan Mtg. (b) (f) | FRE | Dec-02 | Retroactive Restatement | - | - | - | - | - | - | N/M | 10,090.0 | 39.4 | (39.4) | 10,090.0 | 14.18 | 14.18 | 0% |
| Golden West Financial | GDW | Dec-03 | | 1,108.1 | - | (8.2) | 1,097.9 | 7.14 | 7.10 | -1% | 958.3 | - | (3.5) | 954.8 | 8.12 | 8.09 | 0% |
| MGIC Investment | MTG | Dec-03 | | 493.8 | 4.1 | (15.5) | 487.5 | 4.99 | 4.92 | -1% | 829.2 | 2.6 | (12.4) | 819.4 | 5.04 | 5.94 | -2% |
| Washington Mutual | WM | Dec-03 | Prospective | 3,793.0 | 56.0 | (127.0) | 3,722.0 | 4.12 | 4.04 | -2% | 3,789.0 | 28.0 | (87.0) | 3,730.0 | 3.94 | 3.86 | -2% |
| **Total** | | | | **15,485.9** | **124.1** | **(298.9)** | **15,320.2** | | | **-1%** | **20,927.2** | **95.0** | **(273.2)** | **20,749.0** | | | **-1%** |
| ***Financials (84)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **143,956.3** | **3,699.0** | **(7,728.3)** | **139,927.1** | | | **-3%** | **116,529.7** | **2,675.0** | **(8,132.4)** | **112,072.3** | | | **-5%** |
| ***Health Care*** | | | | | | | | | | | | | | | | | |
| ***Biotechnology (5)*** | | | | | | | | | | | | | | | | | |
| Amgen | AMGN | Dec-03 | | 2,259.5 | - | (198.0) | 2,061.5 | 1.69 | 1.55 | -9% | (1,391.9) | - | (189.8) | (1,581.7) | (1.21) | (1.37) | 14% |
| BIOGEN IDEC Inc. | BIIB | Dec-03 | | (875.1) | - | (51.9) | (926.9) | (4.92) | (5.21) | 6% | 148.1 | - | (54.7) | 93.4 | 0.85 | 0.54 | -37% |
| Chiron Corp. | CHIR | Dec-03 | | 226.3 | 5.6 | (100.8) | 125.1 | 1.15 | 0.65 | -43% | 181.1 | 3.2 | (67.1) | 117.2 | 0.94 | 0.61 | -35% |
| Genzyme Corp. | GENZ | Dec-03 | | (97.6) | 0.4 | (80.0) | (147.3) | 0.42 | 0.09 | 118% | 85.2 | 0.6 | (69.7) | 16.3 | 0.81 | 0.55 | -31% |
| Medimmune Inc. | MEDI | Dec-03 | | 183.2 | 2.5 | (87.5) | 98.2 | 0.72 | 0.39 | -46% | (1,096.9) | 12.1 | (96.3) | (1,182.2) | (4.40) | (4.74) | 8% |
| **Total** | | | | **1,726.4** | **8.4** | **(518.2)** | **1,210.5** | | | **-30%** | **(2,075.5)** | **16.1** | **(477.6)** | **(2,537.9)** | | | **NM** |
| ***Health Care Equipment & Supplies (13)*** | | | | | | | | | | | | | | | | | |
| Applera Corp-Applied Biosystems Group | ABI | Jun-03 | | 196.6 | 0.7 | (115.8) | 81.5 | 0.95 | 0.39 | -59% | 168.5 | 2.1 | (101.1) | 69.5 | 0.78 | 0.32 | -59% |
| Bard (C.R.) Inc. | BCR | Dec-03 | | 168.5 | - | (17.2) | 151.3 | 3.20 | 2.88 | -10% | 155.0 | - | (11.8) | 143.2 | 2.94 | 2.71 | -8% |
| Bausch & Lomb | BOL | Dec-03 | | 130.0 | 4.8 | (15.7) | 118.9 | 2.36 | 2.16 | -9% | 86.8 | 4.7 | (18.1) | 75.4 | 1.34 | 1.07 | -16% |
| Baxter International Inc. | BAX | Dec-03 | | 922.0 | 1.0 | (157.0) | 766.0 | 1.52 | 1.27 | -17% | 1,033.0 | 2.0 | (159.0) | 876.0 | 1.67 | 1.43 | -15% |
| Becton, Dickinson | BDX | Sep-03 | | 547.1 | - | (35.9) | 511.1 | 2.07 | 1.95 | -7% | 480.0 | - | (34.9) | 445.1 | 1.79 | 1.66 | -7% |
| Biomet, Inc. | BMET | May-03 | | 286.7 | - | (5.5) | 281.2 | 1.10 | 1.08 | -2% | 239.7 | - | (5.3) | 234.5 | 0.88 | 0.86 | -2% |
| Boston Scientific | BSX | Dec-03 | | 472.0 | 1.0 | (62.0) | 411.0 | 0.56 | 0.49 | -13% | 373.0 | 6.0 | (48.0) | 331.0 | 0.45 | 0.40 | -11% |
| Guidant Corp. | GDT | Dec-03 | | 425.5 | - | (64.3) | 361.2 | 1.36 | 1.15 | -15% | 668.1 | - | (94.8) | 573.3 | 2.18 | 1.87 | -14% |
| Medtronic Inc. | MDT | Apr-03 | | 1,589.8 | - | (179.3) | 1,420.5 | 1.30 | 1.16 | -11% | 964.0 | - | (159.6) | 824.4 | 0.80 | 0.67 | -16% |
| Millipore Corp. | MIL | Dec-03 | | 100.8 | 0.8 | (19.1) | 82.4 | 2.05 | 1.68 | -18% | 80.8 | 1.3 | (15.9) | 66.2 | 1.67 | 1.37 | -18% |
| St Jude Medical | STJ | Dec-03 | | 339.4 | - | (38.0) | 301.4 | 1.83 | 1.63 | -11% | 276.3 | - | (33.2) | 243.1 | 1.51 | 1.33 | -12% |
| Stryker Corp. | SYK | Dec-03 | | 453.5 | - | (19.1) | 434.4 | 2.23 | 2.14 | -4% | 345.8 | - | (17.1) | 328.5 | 1.70 | 1.61 | -5% |
| Zimmer Holdings | ZMH | Dec-03 | | 291.2 | - | (14.3) | 276.9 | 1.38 | 1.31 | -5% | 257.8 | - | (12.7) | 245.1 | 1.31 | 1.25 | -5% |
| **Total** | | | | **5,936.1** | **7.9** | **(746.3)** | **5,197.7** | | | **-12%** | **5,151.5** | **16.1** | **(712.4)** | **4,455.3** | | | **-14%** |
| ***Health Care Providers & Services (17)*** | | | | | | | | | | | | | | | | | |
| Aetna Inc. | AET | Dec-03 | | 933.8 | 40.1 | (81.0) | 892.9 | 5.91 | 5.64 | -4% | 390.2 | 27.4 | (59.4) | 361.2 | 2.57 | 2.37 | -8% |
| AmerisourceBergen Corp. | ABC | Sep-03 | | 441.2 | 0.6 | (19.6) | 422.3 | 3.89 | 3.73 | -4% | 344.9 | 1.5 | (12.3) | 334.1 | 3.16 | 3.06 | -3% |
| Anthem, Inc. | ATH | Dec-03 | | 774.3 | 1.7 | (24.6) | 751.4 | 5.45 | 5.29 | -3% | 548.1 | 1.0 | (14.1) | 536.0 | 4.51 | 4.42 | -2% |
| Cardinal Health, Inc. | CAH | Jun-03 | | 1,411.9 | 1.8 | (85.4) | 1,328.3 | 3.12 | 2.93 | -6% | 1,126.3 | 2.7 | (74.3) | 1,054.7 | 2.45 | 2.29 | -6% |
| CIGNA Corp. | CI | Dec-03 | | 609.0 | 11.0 | (47.0) | 584.0 | 4.41 | 4.16 | -6% | (397.0) | 14.0 | (63.0) | (446.0) | (2.83) | (3.18) | 12% |
| Express Scripts | ESRX | Dec-03 | | 250.6 | 4.4 | (16.3) | 238.8 | 3.17 | 3.01 | -5% | 202.8 | 5.1 | (16.5) | 191.5 | 2.55 | 2.39 | -6% |
| HCA Inc. | HCA | Dec-03 | | 1,332.0 | - | (88.0) | 1,243.0 | 2.81 | 2.43 | -7% | 833.0 | - | (151.0) | 682.0 | 1.59 | 1.30 | -18% |
| Health Management Assoc. | HMA | Sep-03 | | 283.4 | - | (10.2) | 273.2 | 1.13 | 1.08 | -4% | 248.4 | - | (11.2) | 235.3 | 0.97 | 0.91 | -5% |
| Humana Inc. | HUM | Dec-03 | | 228.9 | 3.9 | (8.9) | 223.9 | 1.41 | 1.38 | -2% | 142.8 | 6.8 | (9.8) | 138.8 | 0.85 | 0.83 | -3% |
| IMS Health Inc. | RX | Dec-03 | | 135.3 | 2.4 | (23.2) | 118.5 | 0.66 | 0.48 | -15% | 238.8 | 2.4 | (26.7) | 212.5 | 0.83 | 0.74 | -10% |
| Manor Care Inc. | HCR | Dec-03 | | 119.0 | - | (9.5) | 109.5 | 1.31 | 1.20 | -8% | 131.9 | - | (7.0) | 124.9 | 1.33 | 1.27 | -5% |
| McKesson Corp. | MCK | Mar-03 | | 562.1 | 3.2 | (159.5) | 405.8 | 1.80 | 1.38 | -28% | 421.8 | 6.9 | (168.6) | 260.1 | 1.44 | 0.89 | -38% |
| Medco Health Solutions Inc. | MHS | Dec-03 | | 425.8 | - | (141.4) | 284.4 | 1.57 | 1.05 | -33% | 361.6 | - | (72.7) | 288.9 | 1.34 | 1.07 | -20% |
| Quest Diagnostics | DGX | Dec-03 | | 436.7 | 5.3 | (62.4) | 369.7 | 4.12 | 3.72 | -11% | 322.2 | 9.0 | (47.4) | 283.8 | 3.23 | 2.87 | -12% |
| Tenet Healthcare Corp. (a) | THC | Dec-03 | Retroactive Restatement | (1,404.0) | 88.0 | (88.0) | (1,404.0) | (3.01) | (3.01) | 0% | 744.0 | 90.0 | (90.0) | 744.0 | 1.49 | 1.49 | 0% |
| United Health Group Inc. | UNH | Dec-03 | | 1,825.0 | - | (122.0) | 1,703.0 | 2.96 | 2.76 | -7% | 1,352.0 | - | (101.0) | 1,251.0 | 2.13 | 1.97 | -7% |
| WellPoint Health Networks | WLP | Dec-03 | | 835.2 | 0.5 | (72.0) | 763.7 | 8.18 | 5.69 | -8% | 694.1 | 1.9 | (55.0) | 641.0 | 4.51 | 4.26 | -6% |
| **Total** | | | | **9,318.3** | **160.9** | **(1,047.9)** | **8,428.4** | | | **-10%** | **7,765.9** | **167.7** | **(978.9)** | **6,653.7** | | | **-11%** |
| ***Pharmaceuticals (12)*** | | | | | | | | | | | | | | | | | |
| Abbott Labs | ABT | Dec-03 | | 2,753.2 | - | (300.0) | 2,453.2 | 1.75 | 1.62 | -11% | 2,793.7 | - | (200.0) | 2,593.7 | 1.78 | 1.65 | -7% |
| Allergan, Inc. | AGN | Dec-03 | | (52.5) | 7.2 | (43.6) | (88.9) | (0.40) | (0.68) | 69% | 64.0 | 7.8 | (41.4) | 30.4 | 0.49 | 0.24 | -53% |
| Bristol-Myers Squibb | BMY | Dec-03 | | 3,166.0 | - | (163.0) | 2,923.0 | 1.59 | 1.50 | -6% | 2,067.0 | - | (247.0) | 1,820.0 | 1.06 | 0.93 | -12% |
| Forest Laboratories | FRX | Mar-03 | | 622.0 | - | (32.6) | 589.4 | 1.96 | 1.56 | -5% | 338.0 | - | (65.7) | 272.3 | 0.91 | 0.73 | -19% |
| Johnson & Johnson | JNJ | Dec-03 | | 7,197.0 | - | (349.0) | 6,848.0 | 2.43 | 2.29 | -5% | 6,597.0 | - | (320.0) | 6,277.0 | 2.16 | 2.06 | -5% |
| King Pharmaceuticals | KG | Dec-03 | | 105.8 | - | (1.5) | 104.4 | 0.44 | 0.87 | -1% | 182.5 | - | (8.1) | 174.4 | 0.74 | 0.71 | -4% |
| Lilly (Eli) & Co. | LLY | Dec-03 | | 2,560.9 | - | (220.8) | 2,340.0 | 2.37 | 2.16 | -9% | 2,707.9 | - | (322.1) | 2,385.8 | 2.50 | 2.20 | -12% |
| Merck & Co. | MRK | Dec-03 | | 6,589.8 | 4.9 | (559.4) | 6,035.1 | 2.92 | 2.68 | -8% | 6,794.8 | 1.2 | (487.5) | 6,308.1 | 2.88 | 2.77 | -7% |
| Pfizer, Inc. | PFE | Dec-03 | | 1,639.0 | - | (541.0) | 1,098.0 | 0.22 | 0.14 | -33% | 9,181.0 | - | (518.0) | 8,663.0 | 1.47 | 1.39 | -6% |
| Schering-Plough | SGP | Dec-03 | | (92.0) | 86.0 | (143.0) | (149.0) | (0.06) | (0.12) | 84% | 1,974.0 | 69.0 | (150.0) | 1,893.0 | 1.34 | 1.29 | -4% |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ In Millions)

BEAR STEARNS

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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Watson Pharmaceuticals | WPI | Dec-03 | | 202.9 | - | (20.9) | 182.0 | 1.86 | 1.67 | -10% | 175.8 | - | (30.8) | 145.0 | 1.64 | 1.35 | -18% |
| Wyeth | WYE | Dec-03 | | 2,091.2 | 13.4 | (335.1) | 1,729.5 | 1.54 | 1.29 | -16% | 4,447.2 | 4.0 | (302.2) | 4,149.2 | 3.33 | 3.11 | -7% |
| Total | | | | 26,583.0 | 91.5 | (2,729.8) | 24,044.7 | | | -10% | 37,322.9 | 82.0 | (2,693.0) | 34,711.9 | | | -7% |
| *Health Care (47)* | | | | | | | | | | | | | | | | | |
| *Total* | | | | 43,654.8 | 268.8 | (5,042.2) | 38,881.4 | | | -11% | 48,164.9 | 281.9 | (4,863.8) | 43,523.0 | | | -10% |
| *Industrials* | | | | | | | | | | | | | | | | | |
| *Aerospace & Defense (9)* | | | | | | | | | | | | | | | | | |
| Boeing Company | BA | Dec-03 | Prospective (g) | 718.0 | 456.0 | (456.0) | 718.0 | 0.88 | 0.89 | 0% | 2,318.0 | 447.0 | (447.0) | 2,319.0 | 2.87 | 2.87 | 0% |
| General Dynamics | GD | Dec-03 | | 997.0 | 14.0 | (42.0) | 969.0 | 5.00 | 4.86 | -3% | 1,051.0 | 15.0 | (43.0) | 1,023.0 | 5.18 | 5.04 | -3% |
| Goodrich Corporation | GR | Dec-03 | | 39.5 | - | (18.9) | 19.6 | 0.33 | 0.17 | -48% | 164.2 | - | (17.5) | 146.7 | 1.56 | 1.39 | -11% |
| Honeywell Int'l Inc. | HON | Dec-03 | | 1,344.0 | - | (48.0) | 1,296.0 | 1.56 | 1.50 | -4% | (220.0) | - | (64.0) | (284.0) | (0.27) | (0.35) | 29% |
| Lockheed Martin Corp. | LMT | Dec-03 | | 1,053.0 | - | (61.0) | 992.0 | 2.34 | 2.20 | -6% | 533.0 | - | (67.0) | 466.0 | 1.18 | 1.03 | -13% |
| Northrop Grumman Corp. | NOC | Dec-03 | | 938.0 | 64.0 | (82.0) | 790.0 | 4.32 | 4.22 | -2% | 697.0 | 45.0 | (65.0) | 677.0 | 5.72 | 5.55 | -3% |
| Raytheon Co. | RTN | Dec-03 | | 535.0 | 5.0 | (73.0) | 467.0 | 1.26 | 1.13 | -13% | 758.0 | 4.0 | (63.0) | 697.0 | 1.85 | 1.71 | -8% |
| Rockwell Collins | COL | Sep-03 | | 258.0 | - | (15.0) | 243.0 | 1.43 | 1.35 | -6% | 236.0 | - | (18.0) | 218.0 | 1.28 | 1.19 | -8% |
| United Technologies | UTX | Dec-03 | | 2,361.0 | 8.0 | (133.0) | 2,236.0 | 4.69 | 4.44 | -5% | 2,236.0 | 3.0 | (121.0) | 2,118.0 | 4.42 | 4.19 | -5% |
| Total | | | | 8,112.5 | 547.0 | (928.9) | 7,730.6 | | | -5% | 7,772.2 | 514.0 | (965.8) | 7,360.7 | | | -5% |
| *Air Freight & Logistics (3)* | | | | | | | | | | | | | | | | | |
| FedEx Corporation | FDX | May-03 | | 830.0 | - | (34.0) | 796.0 | 2.74 | 2.63 | -4% | 725.0 | - | (37.0) | 688.0 | 2.39 | 2.27 | -5% |
| Ryder System | R | Dec-03 | | 135.8 | 0.5 | (5.7) | 130.4 | 2.12 | 2.04 | -4% | 112.6 | 0.9 | (5.2) | 108.3 | 1.80 | 1.68 | -6% |
| United Parcel Service | UPS | Dec-03 | Prospective | 2,888.0 | 456.0 | (507.0) | 2,847.0 | 2.56 | 2.50 | -2% | 3,254.0 | 391.0 | (459.0) | 3,186.0 | 2.87 | 2.81 | -2% |
| Total | | | | 3,853.8 | 456.5 | (546.7) | 3,773.4 | | | -2% | 4,091.6 | 391.9 | (501.2) | 3,979.3 | | | -3% |
| *Airlines (2)* | | | | | | | | | | | | | | | | | |
| Delta Air Lines | DAL | Dec-03 | | (773.0) | - | (33.0) | (806.0) | (6.40) | (6.66) | 4% | (1,272.0) | - | (47.0) | (1,319.0) | (10.44) | (10.82) | 4% |
| Southwest Airlines | LUV | Dec-03 | | 442.0 | - | (57.0) | 385.0 | 0.54 | 0.48 | -13% | 241.0 | - | (53.0) | 188.0 | 0.30 | 0.23 | -22% |
| Total | | | | (331.0) | - | (90.0) | (421.0) | | | NM | (1,031.0) | - | (100.0) | (1,131.0) | | | NM |
| *Building Products (5)* | | | | | | | | | | | | | | | | | |
| American Standard | ASD | Dec-03 | | 405.2 | - | (19.9) | 385.3 | 5.50 | 5.23 | -5% | 371.6 | - | (22.4) | 348.6 | 5.04 | 4.74 | -6% |
| Masco Corp | MAS | Dec-03 | Prospective | 740.0 | 41.0 | (53.0) | 728.0 | 1.51 | 1.49 | -2% | 664.0 | 21.0 | (38.0) | 647.0 | 1.29 | 1.26 | -3% |
| Total | | | | 1,145.2 | 41.0 | (72.9) | 1,113.3 | | | -3% | 1,035.6 | 21.0 | (60.4) | 995.6 | | | -4% |
| *Commercial Services & Supplies (13)* | | | | | | | | | | | | | | | | | |
| Allied Waste Industries | AW | Dec-03 | | 111.2 | - | (9.5) | 101.7 | (2.36) | (2.41) | -9% | 196.3 | - | (13.6) | 184.7 | 0.62 | 0.55 | -7% |
| Apollo Group | APOL | Aug-03 | | 247.0 | - | (14.1) | 232.9 | 1.30 | 1.22 | -6% | 161.2 | - | (13.4) | 147.7 | 0.87 | 0.79 | -8% |
| Avery Dennison Corp. | AVY | Dec-03 | | 242.8 | - | (19.4) | 223.4 | 2.43 | 2.24 | -8% | 249.8 | - | (16.5) | 233.3 | 2.51 | 2.34 | -7% |
| Block H&R | HRB | Apr-03 | Prospective | 586.1 | - | (19.6) | 566.2 | 3.15 | 3.06 | -3% | 434.4 | - | (34.0) | 400.4 | 2.31 | 2.13 | -8% |
| Cendant Corporation | CD | Dec-03 | Prospective | 1,465.0 | 10.0 | (50.0) | 1,425.0 | 1.41 | 1.31 | -3% | 1,661.0 | 2.0 | (207.0) | 756.0 | 1.01 | 0.73 | -28% |
| Cintas Corporation | CTAS | May-03 | | 249.3 | - | (3.8) | 245.5 | 1.45 | 1.43 | -2% | 234.3 | - | (4.8) | 229.5 | 1.36 | 1.33 | -2% |
| Deluxe Corp | DLX | Dec-03 | Modified Prospective | 192.5 | 0.8 | (5.1) | 188.0 | 3.49 | 3.42 | -2% | 214.3 | 2.0 | (5.2) | 211.0 | 3.36 | 3.32 | -2% |
| Donnelley (R.R.) & Sons | RRD | Dec-03 | | 176.5 | 1.7 | (11.2) | 167.0 | 1.54 | 1.46 | -5% | 142.2 | 1.5 | (11.7) | 132.0 | 1.24 | 1.15 | -7% |
| Equifax Inc. | EFX | Dec-03 | | 178.5 | - | (12.1) | 166.4 | 1.31 | 1.22 | -7% | 181.3 | - | (14.1) | 167.2 | 1.38 | 1.27 | -7% |
| Monster Worldwide | MNST | Dec-03 | | 7.3 | - | (31.3) | (24.0) | 0.06 | (0.23) | -427% | (15.0) | - | (62.1) | (77.1) | (0.13) | (0.69) | 413% |
| Pitney-Bowes | PBI | Dec-03 | | 494.8 | - | (21.3) | 473.5 | 2.10 | 2.01 | -4% | 437.7 | - | (22.1) | 415.6 | 1.91 | 1.72 | -5% |
| Robert Half International | RHI | Dec-03 | | 6.4 | - | (24.8) | (18.4) | 0.04 | (0.11) | -388% | 2.2 | - | (32.3) | (30.2) | 0.01 | (0.17) | -1491% |
| Waste Management Inc. | WMI | Dec-03 | | 719.0 | - | (68.0) | 651.0 | 1.21 | 1.10 | -9% | 820.0 | - | (85.0) | 735.0 | 1.33 | 1.19 | -10% |
| Total | | | | 4,610.4 | 12.5 | (290.4) | 4,332.5 | | | -6% | 4,121.6 | 5.5 | (911.9) | 3,315.1 | | | -19% |
| *Construction & Engineering (1)* | | | | | | | | | | | | | | | | | |
| Fluor Corp | FLR | Dec-03 | | 179.5 | - | (8.6) | 170.9 | 2.23 | 2.12 | -5% | 170.0 | - | (8.3) | 161.6 | 2.13 | 2.02 | -5% |
| Total | | | | 179.5 | - | (8.6) | 170.9 | | | -5% | 170.0 | - | (8.3) | 161.6 | | | -5% |
| *Electrical Equipment (6)* | | | | | | | | | | | | | | | | | |
| American Power Conversion | APCC | Dec-03 | | 176.9 | - | (23.2) | 153.8 | 0.88 | 0.76 | -13% | 116.5 | - | (25.1) | 91.4 | 0.59 | 0.46 | -22% |
| Cooper Industries, Ltd. | CBE | Dec-03 | Prospective | 274.3 | 6.3 | (12.6) | 268.0 | 2.92 | 2.86 | -2% | 213.7 | (1.0) | (12.9) | 199.8 | 2.28 | 2.14 | -7% |
| Emerson Electric | EMR | Sep-03 | Prospective | 1,013.0 | - | (7.0) | 1,006.0 | 2.41 | 2.39 | -1% | 1,076.0 | - | (17.0) | 1,059.0 | 2.56 | 2.52 | -2% |
| Power-One Inc. | PWER | Dec-03 | | (18.2) | 1.2 | (23.5) | (40.5) | (0.22) | (0.49) | 123% | (211.0) | 0.9 | (24.6) | (234.7) | (2.63) | (2.91) | 11% |
| Rockwell Automation, Inc. | ROK | Sep-03 | | 282.0 | - | (3.0) | 277.0 | 1.49 | 1.46 | -2% | 226.0 | - | (6.0) | 220.0 | 1.20 | 1.17 | -3% |
| Thomas & Betts | TNB | Dec-03 | | 42.8 | - | (5.0) | 37.8 | 0.73 | 0.65 | -12% | (8.2) | - | (4.5) | (12.7) | (0.14) | (0.22) | 54% |
| Total | | | | 1,770.8 | 7.5 | (76.3) | 1,702.1 | | | -4% | 1,413.0 | (0.1) | (90.1) | 1,322.8 | | | -6% |
| *Industrial Conglomerates (4)* | | | | | | | | | | | | | | | | | |
| 3M Company | MMM | Dec-03 | | 2,403.0 | 3.0 | (120.0) | 2,286.0 | 3.02 | 2.88 | -5% | 1,974.0 | 2.0 | (144.0) | 1,932.0 | 2.50 | 2.32 | -7% |
| General Electric | GE | Dec-03 | Prospective | 15,589.0 | 81.0 | (315.0) | 15,355.0 | 1.55 | 1.53 | -2% | 15,132.0 | 27.0 | (330.0) | 14,829.0 | 1.51 | 1.48 | -2% |
| Textron Inc. | TXT | Dec-03 | | 281.0 | 14.0 | (29.0) | 266.0 | 2.05 | 1.94 | -5% | 367.0 | 9.0 | (40.0) | 336.0 | 2.62 | 2.40 | -8% |
| Tyco International | TYC | Sep-03 | | 1,034.7 | 8.1 | (320.8) | 722.0 | 0.52 | 0.36 | -30% | (2,838.2) | - | (415.4) | (3,253.6) | (1.43) | (1.64) | 15% |
| Total | | | | 19,307.7 | 106.1 | (784.8) | 18,629.0 | | | -4% | 14,635.8 | 38.0 | (929.4) | 13,744.4 | | | -6% |
| *Machinery (14)* | | | | | | | | | | | | | | | | | |
| Caterpillar Inc. | CAT | Dec-03 | | 1,099.0 | - | (89.0) | 1,030.0 | 3.13 | 2.93 | -6% | 798.0 | - | (65.0) | 733.0 | 2.36 | 2.13 | -8% |
| Crane Company | CR | Dec-03 | | 104.3 | - | (4.6) | 99.7 | 1.75 | 1.67 | -4% | 16.6 | - | (5.2) | 11.5 | 0.28 | 0.19 | -31% |
| Cummins Inc. | CMI | Dec-03 | Prospective | 54.0 | 3.0 | (4.0) | 53.0 | 1.36 | 1.34 | -2% | 79.0 | 4.0 | (17.0) | 66.0 | 2.06 | 1.72 | -16% |
| Danaher Corp. | DHR | Dec-03 | | 536.8 | - | (26.8) | 510.1 | 3.37 | 3.21 | -5% | 434.1 | - | (21.0) | 413.2 | 2.79 | 2.66 | -5% |
| Deere & Co. | DE | Oct-03 | | 634.4 | 3.0 | (32.0) | 605.4 | 2.64 | 2.53 | -8% | 344.4 | 2.0 | (37.0) | 309.4 | 1.33 | 1.19 | -10% |



BEAR, STEARNS & CO. INC. 383 MADISON AVENUE NEW YORK, NY 10179 (212) 272-2000 WWW.BEARSTEARNS.COM

**APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)**

BEAR STEARNS

Accounting and Taxation Research
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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included In Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease In Net Income) / Increase In Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included In Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease In Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Dover Corp | DOV | Dec-03 | | 285.2 | - | (17.8) | 267.4 | 1.40 | 1.31 | -6% | 207.8 | - | (15.4) | 192.4 | 1.02 | 0.95 | -7% |
| Eaton Corp. | ETN | Dec-03 | | 386.0 | - | (11.0) | 375.0 | 2.56 | 2.48 | -3% | 281.0 | - | (14.0) | 267.0 | 1.96 | 1.86 | -5% |
| Illinois Tool Works | ITW | Dec-03 | | 1,040.2 | 11.8 | (38.6) | 1,018.4 | 3.37 | 3.29 | -2% | 931.8 | - | (25.2) | 906.6 | 3.02 | 2.94 | -3% |
| Ingersoll-Rand Co. Ltd | IR | Dec-03 | | 593.5 | 34.4 | (60.5) | 567.4 | 3.44 | 3.28 | -4% | 365.6 | 4.8 | (32.7) | 337.7 | 2.15 | 1.98 | -8% |
| ITT Industries, Inc | ITT | Dec-03 | | 396.9 | - | (8.0) | 384.9 | 4.15 | 4.08 | -2% | 378.9 | - | (21.4) | 356.5 | 4.06 | 3.83 | -6% |
| Navistar International Corp. | NAV | Oct-03 | | (14.0) | - | (11.0) | (25.0) | (0.21) | (0.37) | 75% | (476.0) | - | (11.0) | (487.0) | (7.85) | (8.07) | 2% |
| PACCAR Inc. | PCAR | Dec-03 | Prospective | 526.5 | 1.7 | (4.7) | 523.5 | 2.99 | 2.97 | -1% | 372.0 | - | (9.5) | 366.5 | 2.13 | 2.10 | -1% |
| Pall Corp. | PLL | Jul-03 | | 103.2 | - | (13.7) | 89.5 | 0.63 | 0.72 | -13% | 73.2 | - | (11.0) | 62.3 | 0.59 | 0.50 | -15% |
| Parker-Hannifin | PH | Jun-03 | | 196.3 | (0.3) | (18.5) | 177.4 | 1.88 | 1.51 | -19% | 130.2 | 0.6 | (15.4) | 115.3 | 1.12 | 0.99 | -11% |
| **Total** | | | | **5,936.3** | **53.8** | **(315.1)** | **5,674.5** | | | **-4%** | **3,937.7** | **11.4** | **(296.7)** | **3,652.4** | | | **-7%** |
| ***Road & Rail (4)*** | | | | | | | | | | | | | | | | | |
| Burlington Northern Santa Fe C | BNI | Dec-03 | | 777.0 | 11.0 | (36.0) | 752.0 | 2.09 | 2.03 | -3% | 760.0 | 10.0 | (32.0) | 738.0 | 2.03 | 1.94 | -3% |
| CSX Corp. | CSX | Dec-03 | Prospective | 189.0 | 3.0 | (34.0) | 156.0 | 0.88 | 0.74 | -16% | 467.0 | 4.0 | (29.0) | 442.0 | 2.19 | 2.06 | -5% |
| Norfolk Southern Corp | NSC | Dec-03 | | 411.0 | 18.0 | (35.0) | 394.0 | 1.05 | 1.01 | -4% | 460.0 | 14.0 | (45.0) | 429.0 | 1.18 | 1.10 | -7% |
| Union Pacific | UNP | Dec-03 | | 1,056.0 | 28.0 | (50.0) | 1,034.0 | 4.07 | 3.99 | -2% | 1,265.0 | 31.0 | (52.0) | 1,244.0 | 4.78 | 4.71 | -2% |
| **Total** | | | | **2,433.0** | **60.0** | **(155.0)** | **2,338.0** | | | **-4%** | **2,952.0** | **59.0** | **(158.0)** | **2,853.0** | | | **-3%** |
| ***Trading Companies & Distributors (1)*** | | | | | | | | | | | | | | | | | |
| Grainger (W W ) Inc. | GWW | Dec-03 | | 227.0 | - | (14.3) | 212.7 | 2.46 | 2.31 | -6% | 235.5 | - | (14.7) | 220.8 | 2.50 | 2.36 | -6% |
| **Total** | | | | **227.0** | **-** | **(14.3)** | **212.7** | | | **-6%** | **235.5** | **-** | **(14.7)** | **220.8** | | | **-6%** |
| ***Industrials (59)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **47,314.5** | **1,284.0** | **(3,282.9)** | **45,316.0** | | | **-4%** | **39,333.3** | **1,940.8** | **(3,879.3)** | **36,694.7** | | | **-7%** |
| ***Information Technology*** | | | | | | | | | | | | | | | | | |
| ***Communications Equipment (14)*** | | | | | | | | | | | | | | | | | |
| ADC Telecommunications | ADCT | Oct-03 | | (76.7) | - | (42.3) | (119.0) | (0.10) | (0.15) | 55% | (1,145.0) | - | (114.4) | (1,259.4) | (1.44) | (1.58) | 10% |
| Andrew Corp. | ANDW | Sep-03 | | 18.7 | - | (7.2) | 11.5 | 0.11 | 0.05 | -39% | 10.5 | - | (6.9) | 3.6 | 0.12 | 0.04 | -66% |
| Avaya Inc. | AV | Sep-03 | | (56.0) | - | 39.0 | (49.0) | (0.23) | (0.13) | -44% | (686.0) | - | (35.0) | (701.0) | (2.44) | (2.54) | 9% |
| CIENA Corp. | CIEN | Oct-03 | | (386.5) | - | (22.8) | (409.3) | (0.87) | (0.92) | 6% | (1,587.5) | - | 40.1 | (1,557.4) | (4.37) | (4.26) | -3% |
| Cisco Systems | CSCO | Jul-03 | | 3,578.0 | - | (1,258.0) | 2,319.0 | 0.50 | 0.32 | -35% | 1,893.0 | - | (1,520.0) | 373.0 | 0.25 | 0.05 | -80% |
| Comverse Technology | CMVT | Jan-04 | | (9.4) | - | (122.5) | (127.9) | (0.03) | (0.07) | 225% | (129.5) | - | (149.8) | (279.3) | (0.69) | (1.49) | 116% |
| Corning Inc. | GLW | Dec-03 | | (223.0) | 1.0 | (162.0) | (384.0) | (0.18) | (0.30) | 72% | (1,780.0) | 1.0 | (278.0) | (2,057.0) | (1.85) | (2.12) | 16% |
| JDS Uniphase Corp | JDSU | Jun-03 | | (937.8) | 50.9 | (565.2) | (1,566.1) | (0.66) | (1.10) | 66% | (8,738.3) | 124.9 | (688.9) | (9,302.3) | (6.50) | (6.92) | 6% |
| Lucent Technologies | LU | Sep-03 | | (770.0) | 17.0 | (285.0) | (1,038.0) | (0.29) | (0.36) | 35% | (11,826.0) | 50.0 | (2,562.0) | (14,338.0) | (3.51) | (4.24) | 21% |
| Motorola Inc | MOT | Dec-03 | | 893.0 | 27.0 | (249.0) | 671.0 | 0.38 | 0.29 | -25% | (2,485.0) | 26.0 | (319.0) | (2,776.0) | (1.09) | (1.22) | 12% |
| QLogic Corp. | QLGC | Mar-03 | | 103.5 | 1.2 | (37.8) | 67.1 | 1.09 | 0.79 | -35% | 70.7 | 1.4 | (30.0) | 42.1 | 0.74 | 0.44 | -40% |
| QUALCOMM Inc. | QCOM | Sep-03 | | 827.4 | 0.6 | (260.4) | 567.7 | 1.01 | 0.69 | -31% | 358.7 | 1.3 | (235.2) | 125.8 | 0.44 | 0.18 | -65% |
| Scientific-Atlanta | SFA | Jun-03 | | 100.3 | - | (58.7) | 41.7 | 0.85 | 0.27 | -68% | 104.4 | - | (68.8) | 35.6 | 0.66 | 0.22 | -66% |
| Tellabs, Inc | TLAB | Dec-03 | | (241.6) | 11.2 | (62.5) | (293.0) | (0.58) | (0.71) | 21% | (313.1) | 10.5 | (129.6) | (432.2) | (0.76) | (1.05) | 38% |
| **Total** | | | | **2,786.0** | **109.0** | **(3,215.3)** | **(310.3)** | | | **-111%** | **(28,242.1)** | **217.0** | **(6,097.4)** | **(32,122.5)** | | | **N/M** |
| ***Computers & Peripherals (10)*** | | | | | | | | | | | | | | | | | |
| Apple Computer | AAPL | Sep-03 | | 68.0 | 15.0 | (181.0) | (98.0) | 0.19 | (0.27) | -244% | 65.0 | 5.0 | (234.0) | (164.0) | 0.18 | (0.46) | -352% |
| Dell Inc | DELL | Jan-04 | | 2,645.0 | - | (829.0) | 1,816.0 | 1.01 | 0.68 | -31% | 2,122.0 | - | (723.0) | 1,399.0 | 0.80 | 0.51 | -34% |
| EMC Corp. | EMC | Dec-03 | | 496.1 | 9.3 | (362.3) | 123.1 | 0.22 | 0.06 | -75% | (118.7) | 5.4 | (364.8) | (475.1) | (0.05) | (0.22) | 300% |
| Gateway Inc. | GTW | Dec-03 | | (514.8) | - | (27.4) | (542.2) | (1.62) | (1.71) | 5% | (297.7) | - | (35.3) | (333.1) | (0.95) | (1.06) | 12% |
| Hewlett-Packard | HPQ | Oct-03 | | 2,539.0 | 29.0 | (792.0) | 1,806.0 | 0.83 | 0.59 | -29% | (963.0) | 73.0 | (797.0) | (1,617.0) | (0.36) | (0.65) | 79% |
| International Bus. Machines | IBM | Dec-03 | | 7,613.0 | 76.0 | (1,101.0) | 6,588.0 | 4.34 | 3.78 | -13% | 5,334.0 | 112.0 | (1,315.0) | 4,131.0 | 3.07 | 2.40 | -23% |
| Lexmark Int'l Inc | LXK | Dec-03 | | 439.2 | - | (39.8) | 399.4 | 3.34 | 3.04 | -8% | 366.7 | - | (32.8) | 333.9 | 2.79 | 2.54 | -9% |
| NCR Corp. | NCR | Dec-03 | | 54.0 | 3.0 | (54.0) | 7.0 | 0.61 | 0.07 | -89% | 128.0 | 4.0 | (58.0) | 74.0 | 1.27 | 0.74 | -42% |
| Network Appliance | NTAP | Apr-03 | | 76.5 | 1.2 | (173.7) | (96.1) | 0.22 | (0.28) | -226% | 3.0 | 2.5 | (264.9) | (259.4) | 0.01 | (0.78) | -8651% |
| Sun Microsystems | SUNW | Jun-03 | | (3,429.0) | 23.0 | (578.0) | (3,984.0) | (1.07) | (1.25) | 16% | (587.0) | 33.0 | (680.0) | (1,234.0) | (0.18) | (0.39) | 110% |
| **Total** | | | | **9,991.0** | **156.5** | **(4,128.3)** | **6,019.2** | | | **-40%** | **6,112.3** | **237.9** | **(4,494.9)** | **1,855.4** | | | **-70%** |
| ***Electronic Equipment & Instruments (16)*** | | | | | | | | | | | | | | | | | |
| Agilent Technologies | A | Oct-03 | | (1,796.0) | - | (941.6) | (2,731.0) | (3.76) | (5.77) | 53% | (1,022.0) | - | (311.0) | (1,333.0) | (2.20) | (2.87) | 30% |
| Jabil Circuit | JBL | Aug-03 | | 43.0 | - | (34.2) | 8.8 | 0.21 | 0.04 | -79% | 34.7 | - | (33.0) | 1.8 | 0.17 | 0.01 | -95% |
| Molex Inc. | MOLX | Jun-03 | | 85.3 | 8.9 | (17.4) | 77.8 | 0.44 | 0.40 | -9% | 76.5 | 9.1 | (14.8) | 70.8 | 0.39 | 0.36 | -7% |
| PerkinElmer | PKI | Dec-03 | | 56.0 | 1.8 | (20.2) | 36.8 | 0.43 | 0.29 | -33% | (4.1) | 1.8 | (21.4) | (24.0) | (0.03) | (0.19) | 481% |
| Sanmina-SCI Corp. | SANM | Sep-03 | | (137.2) | 1.7 | (55.4) | (190.9) | (0.27) | (0.37) | 38% | (2,696.8) | - | (96.9) | (2,793.7) | (5.60) | (5.73) | 2% |
| Solectron | SLR | Aug-03 | | (3,104.9) | - | (107.0) | (3,211.9) | (3.75) | (3.88) | 3% | (3,138.1) | - | (94.7) | (3,232.8) | (4.02) | (4.14) | 3% |
| Symbol Technologies | SBL | Dec-03 | | 3.3 | 6.7 | (20.5) | (10.5) | 0.01 | (0.05) | -419% | (44.9) | (41.3) | (21.0) | (107.8) | (0.20) | (0.47) | 140% |
| Tektronix Inc. | TEK | May-03 | | 35.1 | 0.6 | (20.9) | 14.8 | 0.40 | 0.17 | -58% | 33.8 | 0.3 | (19.2) | 14.6 | 0.36 | 0.18 | -58% |
| Thermo Electron | TMO | Dec-03 | | 172.7 | 1.7 | (21.8) | 152.8 | 1.04 | 0.92 | -12% | 194.4 | 3.1 | (25.7) | 171.8 | 1.12 | 1.01 | -12% |
| Waters Corporation | WAT | Dec-03 | | 170.9 | - | (28.0) | 144.9 | 1.34 | 1.14 | -15% | 152.2 | - | (25.2) | 127.0 | 1.12 | 0.93 | -17% |
| **Total** | | | | **(4,486.7)** | **22.4** | **(1,284.3)** | **(5,708.6)** | | | **N/M** | **(6,414.5)** | **(27.8)** | **(633.9)** | **(7,075.3)** | | | **N/M** |
| ***Internet Software & Services (1)*** | | | | | | | | | | | | | | | | | |
| Yahoo Inc. | YHOO | Dec-03 | | 237.9 | 13.0 | (216.0) | 34.9 | 0.37 | 0.05 | -86% | 106.9 | 5.0 | (488.0) | (376.0) | 0.18 | (0.63) | -452% |
| **Total** | | | | **237.9** | **13.0** | **(216.0)** | **34.9** | | | **-85%** | **106.9** | **5.0** | **(488.0)** | **(376.0)** | | | **-452%** |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR
STEARNS

Accounting and Taxation Research
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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***IT Services (10)*** | | | | | | | | | | | | | | | | | |
| Automatic Data Processing Inc. | ADP | Jun-03 | | 1,018.2 | - | (123.1) | 896.1 | 1.68 | 1.48 | -12% | 1,100.8 | - | (120.0) | 980.8 | 1.75 | 1.56 | -11% |
| Computer Sciences Corp. | CSC | Mar-03 | | 445.2 | 5.1 | (53.2) | 392.1 | 2.54 | 2.26 | -11% | 344.1 | 3.8 | (20.8) | 327.1 | 2.01 | 1.91 | -5% |
| Convergys Corp. | CVG | Dec-03 | | 171.6 | - | (38.5) | 133.1 | 1.15 | 0.90 | -22% | 145.9 | - | (45.2) | 100.7 | 0.86 | 0.61 | -31% |
| Electronic Data Systems | EDS | Dec-03 | | (252.0) | 40.0 | (209.0) | (421.0) | (0.53) | (0.88) | 67% | 1,006.0 | 39.0 | (312.0) | 733.0 | 2.06 | 1.51 | -27% |
| First Data | FDC | Dec-03 | | 1,394.0 | - | (114.0) | 1,280.0 | 1.86 | 1.71 | -8% | 1,232.2 | - | (109.5) | 1,122.7 | 1.60 | 1.45 | -9% |
| Fiserv Inc. | FISV | Dec-03 | | 315.0 | - | (17.0) | 298.0 | 1.61 | 1.52 | -5% | 266.1 | - | (18.2) | 247.9 | 1.37 | 1.27 | -7% |
| Paychex Inc. | PAYX | May-03 | | 293.5 | - | (10.6) | 283.5 | 0.78 | 0.75 | -3% | 274.5 | - | (12.6) | 261.9 | 0.73 | 0.69 | -5% |
| Sabre Holding Corp. | TSG | Dec-03 | | 83.3 | 7.5 | (48.1) | 42.8 | 0.58 | 0.30 | -49% | 214.1 | 19.8 | (41.9) | 192.0 | 1.50 | 1.35 | -10% |
| SunGard Data Systems | SDS | Dec-03 | | 370.3 | - | (69.1) | 301.2 | 1.27 | 1.03 | -19% | 325.6 | - | (54.4) | 271.3 | 1.12 | 0.94 | -17% |
| Unisys Corp. | UIS | Dec-03 | | 258.7 | - | (47.7) | 211.0 | 0.78 | 0.63 | -18% | 223.0 | - | (49.0) | 174.0 | 0.69 | 0.54 | -22% |
| **Total** | | | | **4,092.7** | **52.6** | **(729.7)** | **3,415.7** | | | **-17%** | **5,132.4** | **62.6** | **(783.6)** | **4,411.4** | | | **-14%** |
| ***Office Electronics (1)*** | | | | | | | | | | | | | | | | | |
| Xerox Corp. | XRX | Dec-03 | | 302.0 | - | (85.0) | 217.0 | 0.36 | 0.25 | -28% | 100.0 | - | (83.0) | 17.0 | 0.10 | (0.01) | -83% |
| **Total** | | | | **302.0** | **-** | **(85.0)** | **217.0** | | | **-28%** | **100.0** | **-** | **(83.0)** | **17.0** | | | **-83%** |
| ***Semiconductor & Semiconductor Equipment (18)*** | | | | | | | | | | | | | | | | | |
| Advanced Micro Devices | AMD | Dec-03 | | (274.5) | 1.9 | (80.5) | (353.0) | (0.79) | (1.02) | 29% | (1,303.0) | 2.9 | (148.9) | (1,449.0) | (3.81) | (1.24) | 11% |
| Altera Corp. | ALTR | Dec-03 | | 155.1 | 7.6 | (94.0) | 68.7 | 0.40 | 0.18 | -56% | 91.3 | 8.2 | (96.4) | 3.0 | 0.23 | 0.01 | -97% |
| Analog Devices | ADI | Oct-03 | | 298.3 | 5.7 | (229.4) | 74.6 | 0.76 | 0.20 | -73% | 105.3 | 10.0 | (235.0) | (119.6) | 0.28 | (0.33) | -214% |
| Applied Materials | AMAT | Oct-03 | | (149.1) | - | (389.1) | (538.2) | (0.09) | (0.32) | 261% | 269.0 | - | (316.7) | (47.7) | 0.16 | (0.03) | -118% |
| Applied Micro Circuits | AMCC | Mar-03 | | (543.3) | 131.9 | (435.9) | (847.4) | (2.14) | (3.15) | 47% | (3,605.7) | 147.1 | (314.8) | (3,773.4) | (12.08) | (12.64) | 5% |
| Broadcom Corporation | BRCM | Dec-03 | | (959.9) | 577.5 | (1,025.6) | (1,408.0) | (3.26) | (4.82) | 47% | (2,236.6) | 419.7 | (1,068.3) | (2,885.2) | (8.35) | (10.77) | 29% |
| Intel Corp. | INTC | Dec-03 | | 5,641.0 | - | (981.0) | 4,660.0 | 0.85 | 0.71 | -18% | 3,117.0 | - | (1,170.0) | 1,947.0 | 0.46 | 0.29 | -38% |
| KLA-Tencor Corp. | KLAC | Jun-03 | | 137.2 | - | (90.9) | 46.3 | 0.70 | 0.24 | -66% | 216.2 | - | (123.8) | 92.4 | 1.10 | 0.47 | -57% |
| Linear Technology Corp | LLTC | Jun-03 | | 236.6 | - | (75.9) | 160.7 | 0.74 | 0.50 | -32% | 197.6 | - | (65.7) | 131.9 | 0.60 | 0.40 | -33% |
| LSI Logic | LSI | Dec-03 | | (308.5) | 9.2 | (200.5) | (499.8) | (0.82) | (1.32) | 62% | (292.4) | 36.6 | (253.6) | (509.4) | (0.79) | (1.39) | 75% |
| Maxim Integrated Prod | MXIM | Jun-03 | | 305.6 | - | (139.7) | 165.9 | 0.91 | 0.50 | -45% | 259.2 | - | (171.7) | 87.5 | 0.73 | 0.25 | -66% |
| Micron Technology | MU | Aug-03 | | (1,273.2) | 6.4 | (265.2) | (1,532.0) | (2.11) | (2.59) | 23% | (907.0) | 1.4 | (378.3) | (1,283.9) | (1.51) | (2.14) | 42% |
| National Semiconductor | NSM | May-03 | | (33.3) | 1.9 | (180.9) | (212.3) | (0.18) | (1.17) | 538% | (121.5) | 3.4 | (161.9) | (280.4) | (0.69) | (1.58) | 130% |
| Novellus Systems | NVLS | Dec-03 | | (5.0) | 2.2 | (66.1) | (68.9) | (0.03) | (0.45) | 1269% | 22.9 | 1.2 | (70.2) | (46.1) | 0.15 | (0.32) | -301% |
| NVIDIA Corp. | NVDA | Jan-04 | | 74.4 | 0.5 | (74.5) | 0.4 | 0.43 | - | -99% | 50.8 | 37.3 | (205.4) | (77.3) | 0.54 | (0.50) | -189% |
| PMC-Sierra Inc. | PMCS | Dec-03 | | (9.0) | - | (59.9) | (67.9) | (0.05) | (0.39) | 749% | (65.0) | - | (101.1) | (166.1) | (0.38) | (0.98) | 156% |
| Teradyne Inc. | TER | Dec-03 | | (194.0) | - | (85.1) | (279.1) | (1.03) | (1.49) | 44% | (718.5) | - | (110.3) | (828.8) | (3.93) | (4.53) | 15% |
| Texas Instruments | TXN | Dec-03 | | 1,198.0 | 10.0 | (433.0) | 775.0 | 0.68 | 0.44 | -35% | (344.0) | 7.0 | (415.0) | (752.0) | (0.20) | (0.43) | 119% |
| Xilinx, Inc | XLNX | Mar-03 | | 125.7 | - | (114.3) | 11.4 | 0.36 | 0.03 | -91% | (113.6) | - | (114.3) | (227.9) | (0.34) | (0.68) | 101% |
| **Total** | | | | **4,327.0** | **746.9** | **(8,061.7)** | **14.2** | | | **-100%** | **(5,338.4)** | **668.7** | **(8,522.3)** | **(10,192.1)** | | | **N/M** |
| ***Software (17)*** | | | | | | | | | | | | | | | | | |
| Adobe Systems | ADBE | Nov-03 | | 296.3 | 1.8 | (188.4) | 79.8 | 1.10 | 0.33 | -70% | 191.4 | 4.4 | (189.2) | 6.6 | 0.79 | 0.03 | -97% |
| Autodesk, Inc. | ADSK | Jan-04 | | 120.3 | 1.2 | (45.4) | 76.2 | 1.04 | 0.67 | -37% | 31.9 | 1.9 | (49.9) | (15.1) | 0.28 | (0.13) | -147% |
| BMC Software | BMC | Mar-03 | | 48.0 | 2.3 | (64.7) | (14.4) | 0.20 | (0.06) | -130% | (184.1) | 15.0 | (99.0) | (268.1) | (0.75) | (1.09) | 46% |
| Citrix Systems | CTXS | Dec-03 | | 126.9 | - | (87.6) | 39.3 | 0.74 | 0.23 | -69% | 93.9 | - | (137.6) | (43.7) | 0.52 | (0.25) | -147% |
| Computer Associates Intl | CA | Mar-03 | Prospective | (267.0) | 1.0 | (94.0) | (360.0) | (0.66) | (0.63) | -35% | (1,102.0) | 2.0 | (85.0) | (1,185.0) | (1.91) | (2.05) | 8% |
| Compuware Corp. | CPWR | Mar-03 | | 103.1 | - | (51.9) | 51.2 | 0.27 | 0.14 | -50% | (245.3) | - | (61.8) | (307.2) | (0.66) | (0.83) | 25% |
| Electronic Arts | ERTS | Mar-03 | | 317.1 | - | (83.9) | 233.2 | 2.17 | 1.62 | -28% | 101.5 | - | (73.6) | 27.9 | 0.71 | 0.20 | -73% |
| Intuit, Inc. | INTU | Jul-03 | | 263.2 | 0.8 | (84.4) | 179.6 | 1.25 | 0.65 | -32% | 53.6 | 5.2 | (94.7) | (35.9) | 0.24 | (0.17) | -167% |
| Mercury Interactive | MERQ | Dec-03 | | 41.5 | 5.9 | (141.7) | (94.3) | 0.45 | (1.06) | -327% | 68.2 | 1.2 | (122.2) | (55.8) | 0.74 | (0.67) | -186% |
| Microsoft Corp. | MSFT | Jun-03 | Retroactive Restatement | 9,993.0 | 52.0 | (2,514.0) | 7,531.0 | 0.92 | 0.69 | -25% | 7,829.0 | 99.0 | (2,573.0) | 5,355.0 | 0.70 | 0.48 | -32% |
| Novell Inc. | NOVL | Oct-03 | | (181.9) | 3.4 | (28.8) | (197.3) | (0.44) | (0.51) | 16% | (103.1) | 7.5 | (63.1) | (158.7) | (0.28) | (0.43) | 54% |
| Oracle Corp. | ORCL | May-03 | | 2,307.0 | - | (330.0) | 1,977.0 | 0.43 | 0.36 | -14% | 2,224.0 | - | (460.0) | 1,764.0 | 0.39 | 0.31 | -21% |
| Parametric Technology | PMTC | Sep-03 | | (98.3) | 0.5 | (51.7) | (149.5) | (0.37) | (0.57) | 52% | (93.6) | 0.2 | (101.1) | (194.5) | (0.36) | (0.75) | 108% |
| PeopleSoft Inc. | PSFT | Dec-03 | | 85.0 | 10.5 | (171.0) | (75.5) | 0.25 | (0.22) | -189% | 182.6 | 6.8 | (198.4) | (8.8) | 0.57 | (0.03) | -105% |
| Siebel Systems Inc. | SEBL | Dec-03 | | (3.4) | - | (449.1) | (452.5) | (0.01) | (0.92) | 13223% | (35.7) | - | (1,046.2) | (1,081.9) | (0.08) | (2.27) | 2530% |
| Symantec Corp. | SYMC | Mar-03 | | 248.4 | 0.3 | (89.0) | 159.7 | 1.54 | 1.06 | -36% | (28.2) | - | (79.1) | (107.3) | (0.20) | (0.75) | 281% |
| Veritas Software | VRITAE | Dec-03 | | - | - | - | - | - | - | N/M | 57.4 | - | (294.8) | (237.4) | 0.14 | (0.58) | -514% |
| **Total** | | | | **13,389.4** | **75.7** | **(4,475.6)** | **8,893.5** | | | **-33%** | **9,038.6** | **143.2** | **(5,737.8)** | **3,454.0** | | | **-62%** |
| ***Information Technology (92)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **30,669.3** | **1,152.1** | **(19,175.7)** | **12,675.7** | | | **-59%** | **(17,504.8)** | **1,396.8** | **(23,830.1)** | **(40,028.1)** | | | |
| ***Materials*** | | | | | | | | | | | | | | | | | |
| ***Chemicals (14)*** | | | | | | | | | | | | | | | | | |
| Air Products & Chemicals | APD | Sep-03 | | 400.2 | - | (37.9) | 362.3 | 1.79 | 1.62 | -9% | 525.4 | - | (40.9) | 484.5 | 2.36 | 2.16 | -8% |
| Dow Chemical | DOW | Dec-03 | Prospective | 1,730.0 | 33.0 | (80.0) | 1,692.0 | 1.88 | 1.82 | -3% | (405.0) | 16.0 | (89.0) | (478.0) | (0.44) | (0.52) | 18% |
| Du Pont (E.I.) | DD | Dec-03 | Prospective | 1,002.0 | 31.0 | (125.0) | 908.0 | 0.99 | 0.90 | -9% | 1,641.0 | 3.0 | (171.0) | 1,673.0 | 1.84 | 1.67 | -9% |
| Eastman Chemical | EMN | Dec-03 | | (273.0) | - | (10.0) | (283.0) | (3.54) | (3.68) | 4% | 79.0 | - | (11.0) | 68.0 | 1.02 | 0.88 | -14% |
| Ecolab Inc. | ECL | Dec-03 | | 277.3 | 0.9 | (17.7) | 260.6 | 1.06 | 0.99 | -6% | 211.9 | 1.7 | (15.1) | 198.4 | 0.81 | 0.76 | -6% |
| Engelhard Corp. | EC | Dec-03 | | 236.9 | - | (5.8) | 230.7 | 1.86 | 1.81 | -2% | 171.4 | - | (6.3) | 165.1 | 1.31 | 1.27 | -4% |
| Great Lakes Chemical | GLK | Dec-03 | | (33.9) | 0.4 | (4.2) | (37.7) | (0.67) | (0.75) | 11% | 47.4 | 0.6 | (4.6) | 43.4 | 0.94 | 0.87 | -8% |
| Hercules, Inc. | HPC | Dec-03 | Prospective | 74.0 | 5.0 | (12.0) | 67.0 | 0.69 | 0.62 | -9% | (47.0) | 5.0 | (17.0) | (59.0) | (0.44) | (0.56) | 26% |
| International Flav/Frag | IFF | Dec-03 | | 172.6 | - | (15.4) | 157.2 | 1.83 | 1.66 | -9% | 175.9 | - | (16.0) | 159.9 | 1.84 | 1.67 | -9% |
| Monsanto Co. (e) | MON | Aug-03 | | (88.0) | 1.0 | (7.0) | (94.0) | (0.34) | (0.36) | 7% | 129.0 | 1.0 | (29.0) | 101.0 | 0.49 | 0.38 | -22% |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

Accounting and Taxation Research
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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PPG Industries | PPG | Dec-03 | Modified Prospective | 500.0 | - | (18.0) | 482.0 | 2.92 | 2.81 | -4% | (60.0) | - | (24.0) | (84.0) | (0.36) | (0.50) | 40% |
| Praxair, Inc. | PX | Dec-03 | | 585.0 | - | (27.0) | 558.0 | 1.77 | 1.69 | -5% | 548.0 | - | (25.0) | 523.0 | 1.66 | 1.59 | -5% |
| Rohm & Haas | ROH | Dec-03 | Prospective | 288.0 | 7.0 | (26.0) | 269.0 | 1.30 | 1.21 | -7% | 210.0 | 2.0 | (23.0) | 185.0 | 0.95 | 0.86 | -10% |
| Sigma-Aldrich | SIAL | Dec-03 | | 190.4 | - | (11.1) | 179.3 | 2.68 | 2.53 | -6% | 186.7 | - | (10.5) | 176.2 | 2.54 | 2.40 | -5% |
| **Total** | | | | **5,070.2** | **78.3** | **(397.1)** | **4,751.4** | | | **-6%** | **3,613.4** | **29.3** | **(481.3)** | **3,161.2** | | | **-13%** |
| ***Construction Materials (1)*** | | | | | | | | | | | | | | | | | |
| Vulcan Materials | VMC | Dec-03 | | 223.5 | 2.6 | (7.1) | 219.0 | 2.18 | 2.13 | -2% | 196.7 | 0.6 | (5.4) | 191.8 | 1.92 | 1.87 | -2% |
| **Total** | | | | **223.5** | **2.6** | **(7.1)** | **219.0** | | | **-2%** | **196.7** | **0.6** | **(5.4)** | **191.8** | | | **-2%** |
| ***Containers & Packaging (5)*** | | | | | | | | | | | | | | | | | |
| Ball Corp. | BLL | Dec-03 | | 229.9 | 7.6 | (8.8) | 228.7 | 4.02 | 4.00 | -1% | 156.1 | 4.2 | (8.0) | 152.3 | 2.71 | 2.64 | -3% |
| Bemis Company | BMS | Dec-03 | | 147.1 | 8.6 | (8.0) | 145.7 | 1.37 | 1.35 | -1% | 165.5 | 9.4 | (10.5) | 164.4 | 1.54 | 1.53 | -1% |
| Pactiv Corp. | PTV | Dec-03 | | 195.0 | 4.0 | (14.0) | 185.0 | 1.21 | 1.15 | -5% | 320.0 | 4.0 | (13.0) | 311.0 | 1.37 | 1.31 | -4% |
| Sealed Air Corp. | SEE | Dec-03 | | 249.4 | - | - | 249.4 | 2.00 | 2.00 | 0% | (309.1) | - | - | (309.1) | (4.30) | (4.30) | 0% |
| Temple-Inland | TIN | Dec-03 | Prospective | 97.0 | 21.0 | (31.0) | 87.0 | 1.78 | 1.60 | -10% | 55.0 | 8.0 | (16.0) | 57.0 | 1.25 | 1.09 | -12% |
| **Total** | | | | **909.4** | **39.2** | **(61.8)** | **886.8** | | | **-2%** | **387.5** | **25.6** | **(47.5)** | **275.4** | | | **-1%** |
| ***Metals & Mining (6)*** | | | | | | | | | | | | | | | | | |
| Alcoa Inc | AA | Dec-03 | | 1,034.0 | - | (30.0) | 1,004.0 | 1.20 | 1.18 | -3% | 476.0 | - | (113.0) | 363.0 | 0.56 | 0.43 | -24% |
| Allegheny Technologies Inc | ATI | Dec-03 | | (313.3) | 7.9 | (11.2) | (316.6) | (3.87) | (3.91) | 1% | (85.8) | 0.5 | (4.3) | (89.6) | (0.82) | (0.86) | 6% |
| Freeport-McMoran Cp & Gld | FCX | Dec-03 | | 197.3 | 9.5 | (14.2) | 192.5 | 1.07 | 1.02 | -2% | 167.7 | 2.3 | (8.8) | 161.2 | 0.88 | 0.82 | -4% |
| Newmont Mining Corp. (Hldg. Co.) | NEM | Dec-03 | | 510.2 | - | (15.3) | 494.9 | 1.23 | 1.18 | -3% | 150.4 | - | (9.8) | 140.6 | 0.38 | 0.36 | -7% |
| Nucor Corp. | NUE | Dec-03 | | 82.8 | - | (7.4) | 55.4 | 0.80 | 0.71 | -12% | 162.1 | - | (5.2) | 156.9 | 2.07 | 2.01 | -3% |
| Phelps Dodge | PD | Dec-03 | | 18.1 | - | (11.2) | 6.9 | 0.06 | (0.06) | -62% | (315.2) | - | (13.8) | (329.0) | (3.86) | (4.02) | 4% |
| United States Steel Corp. | X | Dec-03 | | (406.0) | 48.0 | (45.0) | (403.0) | (4.09) | (4.06) | -1% | 61.0 | 3.0 | (7.0) | 57.0 | 0.62 | 0.58 | -7% |
| Worthington Ind. | WOR | May-03 | | 75.2 | - | (1.5) | 73.7 | 0.87 | 0.86 | -2% | 6.5 | - | (1.4) | 5.1 | 0.08 | 0.06 | -22% |
| **Total** | | | | **1,178.2** | **65.4** | **(135.8)** | **1,107.9** | | | **-6%** | **642.9** | **5.8** | **(163.3)** | **485.1** | | | **-25%** |
| ***Paper & Forest Products (5)*** | | | | | | | | | | | | | | | | | |
| Georgia-Pacific Group | GP | Dec-03 | Prospective | 226.0 | - | (8.0) | 218.0 | 0.90 | 0.87 | -4% | (190.0) | - | (25.0) | (215.0) | (0.80) | (0.91) | 13% |
| International Paper | IP | Dec-03 | | 315.0 | - | (44.0) | 271.0 | 0.66 | 0.57 | -14% | 295.0 | - | (41.0) | 254.0 | 0.61 | 0.52 | -14% |
| Louisiana Pacific | LPX | Dec-03 | | 284.0 | 5.2 | (8.4) | 280.8 | 2.67 | 2.64 | -1% | (2.9) | 2.2 | (4.2) | (4.9) | (0.03) | (0.05) | 69% |
| MeadWestvaco Corporation (c) | MWV | Dec-03 | | (2.0) | - | (5.0) | (7.0) | (0.01) | (0.04) | 250% | (3.0) | - | (2.0) | (5.0) | (0.01) | (0.02) | 67% |
| Weyerhaeuser Corp. | WY | Dec-03 | | 288.0 | - | (25.0) | 263.0 | 1.30 | 1.18 | -9% | 241.0 | - | (31.0) | 210.0 | 1.09 | 0.95 | -13% |
| **Total** | | | | **1,111.0** | **5.2** | **(90.4)** | **1,025.8** | | | **-8%** | **340.1** | **2.2** | **(103.3)** | **239.1** | | | **-30%** |
| ***Materials (23)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **8,492.3** | **190.7** | **(692.3)** | **7,990.7** | | | **-6%** | **5,890.7** | **63.5** | **(801.4)** | **4,352.8** | | | **-14%** |
| ***Telecommunication Services*** | | | | | | | | | | | | | | | | | |
| ***Diversified Telecommunication Services (9)*** | | | | | | | | | | | | | | | | | |
| ALLTEL Corp. | AT | Dec-03 | | 953.5 | - | (24.6) | 928.9 | 3.05 | 2.97 | -3% | 850.1 | - | (31.1) | 819.0 | 2.72 | 2.62 | -4% |
| AT&T Corp. | T | Dec-03 | Prospective | 1,863.0 | 73.0 | (225.0) | 1,713.0 | 2.36 | 2.17 | -8% | 963.0 | 99.0 | (401.0) | 661.0 | 1.26 | 0.87 | -31% |
| BellSouth | BLS | Dec-03 | Retroactive Restatement | 3,569.0 | 72.0 | (72.0) | 3,569.0 | 1.94 | 1.90 | 0% | 2,608.0 | 100.0 | (100.0) | 2,608.0 | 1.39 | 1.34 | 0% |
| Century Telephone | CTL | Dec-03 | | 344.7 | - | (13.2) | 331.5 | 2.38 | 2.29 | -4% | 193.5 | - | (15.0) | 178.5 | 1.35 | 1.25 | -8% |
| Citizens Communications | CZN | Dec-03 | | 122.1 | 6.3 | (16.3) | 112.1 | 0.42 | 0.39 | -8% | (823.0) | 5.1 | (17.2) | (835.1) | (2.93) | (2.99) | 1% |
| Qwest Communications Int | Q | Dec-03 | | (1,313.0) | 6.0 | (104.0) | (1,411.0) | (0.76) | (0.82) | 7% | (17,618.0) | 71.0 | (201.0) | (17,748.0) | (10.48) | (10.56) | 1% |
| SBC Communications Inc. (c) | SBC | Dec-03 | Retroactive Restatement | 5,971.0 | 146.4 | (148.4) | 5,971.0 | 1.80 | 1.80 | 0% | 7,473.0 | 223.8 | (223.8) | 7,473.0 | 2.23 | 2.23 | 0% |
| Sprint Corp. FON | FON | Dec-03 | Prospective | 294.0 | 19.0 | (47.0) | 266.0 | 0.33 | 0.29 | -10% | 1,049.0 | 3.0 | (91.0) | 961.0 | 1.18 | 1.08 | -8% |
| Verizon Communications | VZ | Dec-03 | Prospective | 3,509.0 | 44.0 | (215.0) | 3,338.0 | 1.27 | 1.21 | -5% | 4,861.0 | - | (467.0) | 4,194.0 | 1.79 | 1.53 | -10% |
| **Total** | | | | **15,533.3** | **368.7** | **(883.4)** | **14,638.5** | | | **-3%** | **(843.3)** | **501.9** | **(1,547.1)** | **(1,888.5)** | | | **NM** |
| ***Wireless Telecommunication Services (3)*** | | | | | | | | | | | | | | | | | |
| AT&T Wireless Services | AWE | Dec-03 | | 442.0 | 5.0 | (164.0) | 283.0 | 0.16 | 0.10 | -38% | (2,205.0) | 4.0 | (362.0) | (2,563.0) | (0.82) | (0.95) | 16% |
| Nextel Communications | NXTL | Dec-03 | | 1,537.0 | 35.0 | (360.0) | 1,212.0 | 1.36 | 1.07 | -21% | 1,386.0 | 8.0 | (350.0) | 1,044.0 | 1.78 | 1.43 | -25% |
| Sprint Corp. PCS | PCS | Dec-03 | Prospective | (681.0) | 14.0 | (98.0) | (765.0) | (0.66) | (0.70) | 7% | (578.0) | 2.0 | (127.0) | (703.0) | (0.58) | (0.71) | 22% |
| **Total** | | | | **1,318.0** | **54.0** | **(683.0)** | **735.0** | | | **-40%** | **(1,397.0)** | **14.0** | **(839.0)** | **(2,222.0)** | | | **NM** |
| ***Telecommunication Services (12)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **16,851.3** | **422.7** | **(1,566.4)** | **15,627.5** | | | **-8%** | **(2,240.3)** | **515.9** | **(2,386.1)** | **(3,910.5)** | | | **NM** |
| ***Utilities*** | | | | | | | | | | | | | | | | | |
| ***Electric Utilities (22)*** | | | | | | | | | | | | | | | | | |
| Allegheny Energy | AYE | Dec-03 | | (334.2) | 6.4 | (7.8) | (335.6) | (2.64) | (2.65) | 0% | (502.2) | - | (4.1) | (506.3) | (4.00) | (4.00) | 1% |
| Ameren Corporation | AEE | Dec-03 | Prospective | 506.0 | 3.0 | (3.0) | 506.0 | 3.14 | 3.14 | 0% | 382.0 | 1.2 | (3.0) | 380.2 | 2.60 | 2.60 | 0% |
| American Electric Power | AEP | Dec-03 | | 522.0 | 2.0 | (7.0) | 517.0 | 1.35 | 1.33 | -1% | 485.0 | (5.0) | (4.0) | 476.0 | 1.46 | 1.44 | -2% |
| CenterPoint Energy | CNP | Dec-03 | | 419.7 | - | (10.0) | 409.7 | 1.37 | 1.34 | -2% | 368.6 | - | (9.0) | 359.6 | 1.23 | 1.23 | -2% |
| Cinergy Corp. | CIN | Dec-03 | Prospective | 434.4 | 17.0 | (18.0) | 433.4 | 2.43 | 2.43 | 0% | 396.6 | 24.0 | (23.0) | 397.6 | 2.34 | 2.35 | 0% |
| CMS Energy | CMS | Dec-03 | Prospective | (43.0) | 5.0 | (5.0) | (43.0) | (0.30) | (0.30) | 0% | (394.0) | 4.0 | (4.0) | (394.0) | (2.84) | (2.84) | 0% |
| Consolidated Edison | ED | Dec-03 | | 536.0 | 3.0 | (8.0) | 531.0 | 2.38 | 2.34 | -1% | 680.0 | 8.0 | (13.0) | 673.0 | 3.13 | 3.18 | 1% |
| Dominion Resources | D | Dec-03 | | 949.0 | 10.0 | (36.0) | 923.0 | 2.98 | 2.90 | -3% | 1,362.0 | 6.0 | (52.0) | 1,315.0 | 4.82 | 4.65 | -3% |
| DTE Energy Co. | DTE | Dec-03 | | 480.0 | - | (7.0) | 473.0 | 2.85 | 2.81 | -1% | 586.0 | - | (7.0) | 579.0 | 3.55 | 3.51 | -1% |
| Edison Int'l | EIX | Dec-03 | | 820.7 | 7.0 | (9.0) | 818.7 | 2.37 | 2.36 | 0% | 1,077.4 | 8.0 | (9.0) | 1,076.4 | 3.46 | 3.47 | 0% |



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APPENDIX B: Pro Forma Income From Continuing Operations of the S&P 500 By Sector and Industry Group ($ In Millions)

BEAR
STEARNS

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| | | | | 2003 | | | | | | | | 2002 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included In Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | Reported EPS from Cont. Oper. | Pro Forma EPS from Cont. Oper. | (Decrease In Net Income) / Increase In Net Loss from Cont. Oper. | Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included In Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | Reported EPS from Cont. Oper. | Pro Forma EPS from Cont. Oper. | (Decrease In Net Income) / Increase In Net Loss from Cont. Oper. |
| Entergy Corp. | ETR | Dec-03 | Prospective | 813.4 | 2.8 | (24.5) | 791.7 | 3.42 | 3.33 | -3% | 623.1 | - | (28.1) | 595.0 | 2.64 | 2.51 | -5% |
| Exelon Corp. | EXC | Dec-03 | | 793.0 | - | (20.0) | 773.0 | 2.41 | 2.35 | -3% | 1,670.0 | - | (33.0) | 1,637.0 | 5.15 | 5.04 | -2% |
| FirstEnergy Corp. | FE | Dec-03 | | 422.0 | 0.2 | (12.4) | 409.8 | 1.39 | 1.35 | -3% | 632.7 | 0.2 | (8.8) | 624.0 | 2.15 | 2.12 | -1% |
| FPL Group | FPL | Dec-03 | | 893.0 | - | (7.0) | 886.0 | 5.02 | 4.96 | -1% | 695.0 | - | (7.0) | 688.0 | 4.01 | 3.97 | -1% |
| PG&E Corp. | PCG | Dec-03 | | 791.0 | - | (19.0) | 772.0 | 1.96 | 1.81 | -2% | 1,723.0 | - | (20.0) | 1,703.0 | 4.50 | 4.44 | -1% |
| Pinnacle West Capital | PNW | Dec-03 | Prospective | 230.6 | 1.3 | (3.0) | 228.9 | 2.52 | 2.50 | -1% | 206.2 | 0.3 | (1.7) | 204.8 | 2.43 | 2.41 | -1% |
| PPL Corp. | PPL | Dec-03 | Prospective | 718.0 | 5.0 | (9.0) | 715.0 | 4.15 | 4.13 | -1% | 360.0 | 3.0 | (8.0) | 355.0 | 2.36 | 2.33 | -1% |
| Progress Energy, Inc. | PGN | Dec-03 | | 811.0 | - | (11.0) | 800.0 | 3.40 | 3.36 | -1% | 552.0 | - | (8.0) | 544.0 | 2.53 | 2.50 | -1% |
| Southern Co. | SO | Dec-03 | | 1,474.0 | - | (18.0) | 1,456.0 | 2.02 | 1.99 | -1% | 1,318.0 | - | (19.0) | 1,299.0 | 1.85 | 1.82 | -1% |
| TECO Energy | TE | Dec-03 | | (14.7) | - | (2.7) | (17.4) | (0.08) | (0.10) | 18% | 277.2 | - | (5.1) | 272.1 | 1.81 | 1.78 | -2% |
| TXU Corp. | TXU | Dec-03 | | 737.0 | - | - | 737.0 | 2.03 | 2.03 | 0% | 182.0 | - | - | 182.0 | 0.58 | 0.58 | 0% |
| Xcel Energy Inc | XEL | Dec-03 | | 910.0 | - | (6.2) | 903.8 | 1.23 | 1.22 | -1% | 527.7 | - | (7.0) | 520.7 | 1.37 | 1.35 | -1% |
| **Total** | | | | **12,489.3** | **62.7** | **(243.8)** | **12,265.0** | | | **-1%** | **13,268.5** | **46.7** | **(269.8)** | **12,985.4** | | | **-2%** |
| ***Gas Utilities (8)*** | | | | | | | | | | | | | | | | | |
| Keyspan Energy | KSE | Dec-03 | Prospective | 424.2 | 3.7 | (9.4) | 418.5 | 2.82 | 2.59 | -1% | 397.4 | 0.2 | (7.5) | 390.0 | 2.75 | 2.70 | -2% |
| Kinder Morgan | KMI | Dec-03 | | 381.7 | 2.1 | (16.5) | 367.3 | 3.08 | 2.97 | -4% | 307.7 | 0.9 | (15.4) | 293.2 | 2.49 | 2.37 | -5% |
| NICOR Inc. | GAS | Dec-03 | | 168.6 | - | (0.7) | 165.1 | 2.48 | 2.47 | -1% | 128.0 | - | (0.8) | 127.4 | 2.88 | 2.87 | 0% |
| NISource Inc. | NI | Dec-03 | | 425.7 | 8.3 | (15.0) | 419.0 | 1.63 | 1.60 | -2% | 398.1 | 4.5 | (11.0) | 391.6 | 1.87 | 1.84 | -2% |
| Peoples Energy | PGL | Sep-03 | | 103.9 | - | (0.8) | 103.1 | 2.87 | 2.85 | -1% | 89.1 | - | (1.6) | 87.5 | 2.51 | 2.46 | -2% |
| Sempra Energy | SRE | Dec-03 | | 695.0 | 13.0 | (20.0) | 688.0 | 3.24 | 3.20 | -1% | 575.0 | 3.0 | (11.0) | 567.0 | 2.87 | 2.83 | -1% |
| **Total** | | | | **2,140.3** | **27.1** | **(62.4)** | **2,105.0** | | | **-2%** | **1,895.2** | **8.6** | **(47.1)** | **1,856.7** | | | **-2%** |
| ***Multi-Utilities & Unregulated Power (8)*** | | | | | | | | | | | | | | | | | |
| AES Corp. | AES | Dec-03 | Prospective | 336.0 | 7.0 | (7.0) | 336.0 | 0.56 | 0.56 | 0% | (1,609.0) | - | (148.0) | (1,757.0) | (2.99) | (3.27) | 9% |
| Calpine Corp. | CPN | Dec-03 | Prospective | 109.8 | 9.7 | (21.3) | 98.1 | 0.28 | 0.25 | -11% | 53.7 | - | (35.6) | 18.1 | 0.15 | 0.05 | -66% |
| Constellation Energy Group | CEG | Dec-03 | | 475.7 | 12.0 | (20.7) | 467.0 | 2.95 | 2.80 | -2% | 525.6 | 8.6 | (17.1) | 514.9 | 3.20 | 3.13 | -2% |
| Duke Energy | DUK | Dec-03 | | (1,005.0) | 6.0 | (30.0) | (1,029.0) | (1.13) | (1.16) | 2% | 1,295.0 | 9.0 | (70.0) | 1,234.0 | 1.53 | 1.46 | -5% |
| Dynegy Inc. Class A | DYN | Dec-03 | Prospective | (474.0) | 2.0 | (53.0) | (525.0) | 1.30 | 1.18 | 11% | (1,349.0) | 8.0 | (84.0) | (1,425.0) | (4.59) | (4.80) | 5% |
| El Paso Corp. (b) | EP | Dec-02 | | - | - | - | - | | | NM | (1,269.0) | - | (143.0) | (1,412.0) | (2.30) | (2.98) | 31% |
| Public Serv. Enterprise Inc. | PEG | Dec-03 | | 852.0 | - | (8.0) | 844.0 | 3.72 | 3.68 | -1% | 405.0 | - | (10.0) | 395.0 | 1.94 | 1.89 | -3% |
| Williams Cos. | WMB | Dec-03 | | 15.2 | 18.7 | (31.6) | 2.3 | (0.03) | (0.05) | -66% | (611.7) | 19.1 | (34.5) | (627.1) | (1.35) | (1.38) | 3% |
| **Total** | | | | **359.7** | **55.4** | **(171.6)** | **193.4** | | | **-38%** | **(2,578.4)** | **42.5** | **(542.2)** | **(3,079.1)** | | | **NMF** |
| ***Utilities (35)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **14,919.9** | **145.2** | **(477.8)** | **14,567.5** | | | **-2%** | **12,524.3** | **97.8** | **(859.1)** | **11,763.0** | | | **-6%** |

*Source: Company reports; FactSet Research Systems Inc., Standard and Poor's; Bear Stearns estimates.*

The S&P 500 as of March 19, 2004

N/A Not available.
NM Not meaningful.

(a) In 2002, Tenet Healthcare changed from a May yearend to a December, as a result, 2001 information is not comparable. Tenet does not explicitly state whether the stock option expense stated is pre or post tax. Tenet does not disclose stock option expense on a post-tax basis, therefore, we estimated post-tax stock-based compensation expense
(b) El Paso, Federal Home Loan, and Goodyear Tire & Rubber are December yearend companies that have not yet released their 2003 10Ks.
( c) Lincoln National, SBC, and Wal-Mart adopted the retroactive restatement method and presents stock-based compensation as a pre-tax expense rather than a post-tax expense. To estimate the post-tax expense we applied a 40% tax rate.
(d) In 2001, MeadWestvaco Corporation switched from an October to a December fiscal yearend
(e) In 2003, Monsanto changed from a December 31 yearend to an August 31 yearend. To estimate an expense that was comparable to 2001 and 2002, 2003 information represents eleven months including the eight month period from January 1, 2003 to August 31, 2003, as well as, first quarter of fiscal 2004.
(f) Simon Property Group and Federal Home Loan Mtg presented its stock-based compensation as a pre-tax figure. To estimate the post-tax expense we applied a 40% tax rate.
(g) The company adopted FAS No. 123 before the issuance of FAS No. 148, therefore, the prospective method was the only method of adoption available to the company.



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**APPENDIX C: Pro Forma Income From Continuing Operations of the NASDAQ 100 By Sector and Industry Group ($ in Millions)**

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| | | 2003 | | | | | 2002 | | | | | 2001 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sector (# of Companies) | Industry Group Name (# of Companies) | Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included in Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included in Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included in Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
| Consumer Discretionary (13) | Auto Components (1) | 107 | - | (11) | 96 | -10% | 86 | - | (8) | 78 | -9% | 65 | - | (7) | 58 | -11% |
| | Hotels Restaurants & Leisure (1) | 268 | - | (37) | 231 | -14% | 213 | - | (37) | 175 | -18% | 180 | - | (41) | 140 | -22% |
| | Internet & Catalog Retail (1) | 447 | 5 | (202) | 251 | -44% | 251 | 6 | (183) | 63 | -75% | 90 | 3 | (212) | (118) | -230% |
| | Media (2) | (253) | 10 | (175) | (419) | NM | (505) | 11 | (152) | (646) | NM | (105) | 10 | (144) | (236) | NM |
| | Multiline Retail (1) | 178 | - | (13) | 164 | -7% | 155 | - | (13) | 142 | -8% | 123 | - | (11) | 112 | -9% |
| | Specialty Retail (8) | 1,244 | 170 | (935) | 1,080 | -13% | 712 | 84 | (379) | 418 | -41% | (162) | 14 | (564) | (712) | NM |
| | Sector Total | 1,991 | 185 | (773) | 1,404 | -30% | 910 | 101 | (782) | 230 | -75% | 193 | 27 | (678) | (756) | -494% |
| Consumer Staples (2) | Food & Staples Retailing (2) | 825 | 8 | (88) | 744 | -10% | 784 | - | (90) | 695 | -11% | 654 | - | (77) | 576 | -12% |
| | Sector Total | 825 | 8 | (88) | 744 | -10% | 784 | - | (90) | 695 | -11% | 654 | - | (77) | 576 | -12% |
| Energy (1) | Energy Equipment & Services (1) | 56 | - | (11) | 45 | -19% | 2 | - | (5) | (3) | -244% | 164 | - | (7) | 157 | -4% |
| | Sector Total | 56 | - | (11) | 45 | -19% | 2 | - | (5) | (3) | -244% | 164 | - | (7) | 157 | -4% |
| Health Care (17) | Biotechnology (9) | 1,309 | 13 | (716) | 606 | -54% | (2,371) | 19 | (759) | (3,111) | NM | 1,085 | 17 | (756) | 346 | -68% |
| | Health Care Equipment & Supplies (2) | 457 | - | (17) | 440 | -4% | 383 | - | (15) | 368 | -4% | 315 | - | (10) | 305 | -3% |
| | Health Care Providers & Services (5) | 891 | 5 | (55) | 841 | -6% | 738 | 5 | (57) | 687 | -7% | 526 | 6 | (48) | 484 | -8% |
| | Pharmaceuticals (1) | 691 | 1 | (55) | 637 | -8% | 410 | 0 | (59) | 352 | -14% | 278 | 1 | (29) | 250 | -10% |
| | Sector Total | 3,348 | 16 | (842) | 2,523 | -25% | (839) | 24 | (890) | (1,703) | NM | 2,205 | 23 | (843) | 1,385 | -37% |
| Industrials (9) | Air Freight & Logistics (2) | 236 | - | (30) | 206 | -13% | 209 | - | (28) | 181 | -12% | 181 | - | (17) | 164 | -10% |
| | Airlines (1) | 242 | - | (15) | 227 | -6% | 156 | - | (2) | 153 | -1% | 132 | - | (9) | 124 | -8% |
| | Commercial Services & Supplies (3) | 615 | - | (30) | 585 | -5% | 463 | - | (27) | 436 | -6% | 369 | - | (23) | 346 | -6% |
| | Electrical Equipment (1) | 177 | - | (23) | 154 | -13% | 117 | - | (25) | 91 | -22% | 113 | - | (48) | 66 | -42% |
| | Machinery (1) | 527 | 2 | (5) | 524 | -1% | 372 | - | (6) | 367 | -1% | 174 | - | (6) | 168 | -3% |
| | Trading Companies & Distributors (1) | 84 | - | (2) | 82 | -2% | 76 | - | (3) | 73 | -4% | 70 | - | (3) | 68 | -4% |
| | Sector Total | 1,881 | 2 | (105) | 1,777 | -6% | 1,391 | - | (69) | 1,303 | -5% | 1,019 | - | (104) | 915 | -10% |
| Information Technology (55) | Communications Equipment (11) | 2,901 | 120 | (2,619) | 402 | -86% | (6,576) | 258 | (2,999) | (11,316) | NM | (62,249) | 309 | (3,131) | (65,071) | NM |
| | Computers & Peripherals (6) | (458) | 65 | (1,773) | (2,167) | NM | 1,391 | 40 | (1,942) | (311) | -120% | 1,949 | 32 | (1,896) | 84 | -96% |
| | Electronic Equipment & Instruments (4) | 40 | 12 | (154) | (102) | -356% | (2,588) | 10 | (175) | (2,754) | NM | (33) | 9 | (246) | (270) | NM |
| | Internet Software & Services (1) | 236 | 13 | (216) | 35 | -85% | 107 | 3 | (486) | (376) | -452% | (93) | 9 | (900) | (993) | NM |
| | IT Services (2) | 808 | - | (27) | 581 | -4% | 541 | - | (31) | 510 | -6% | 463 | - | (24) | 439 | -5% |
| | Semiconductor & Semiconductor Equipment (14) | 5,644 | 629 | (3,302) | 2,962 | -48% | 1,480 | 458 | (3,593) | (1,614) | -209% | 921 | 537 | (3,206) | (1,751) | -290% |
| | Software (17) | 14,691 | 88 | (4,722) | 9,457 | -33% | 5,638 | 135 | (5,934) | (159) | -103% | (2,446) | 178 | (5,498) | (7,767) | NM |
| | Sector Total | 23,863 | 918 | (12,812) | 11,168 | -52% | (1,907) | 949 | (15,162) | (16,020) | NM | (61,488) | 1,074 | (14,905) | (75,319) | NM |
| Materials (2) | Chemicals (1) | 190 | - | (11) | 179 | -6% | 187 | - | (10) | 177 | -5% | 153 | - | (12) | 141 | -8% |
| | Containers & Packaging (1) | (198) | 2 | (12) | (208) | NM | 59 | - | (13) | 46 | -22% | 52 | - | (11) | 42 | -21% |
| | Sector Total | (8) | 2 | (23) | (29) | NM | 246 | - | (23) | 223 | -9% | 206 | - | (23) | 183 | -11% |
| Telecommunication Services (2) | Diversified Telecommunication Services (1) | 100 | 1 | (9) | 92 | -8% | 85 | - | (9) | 76 | -11% | 31 | - | (17) | 14 | -55% |
| | Wireless Telecommunication Services (1) | 1,537 | 35 | (360) | 1,212 | -21% | 1,386 | 8 | (350) | 1,044 | -25% | (2,625) | 15 | (244) | (2,854) | NM |
| | Sector Total | 1,637 | 36 | (369) | 1,304 | -20% | 1,471 | 8 | (359) | 1,120 | -24% | (2,594) | 15 | (261) | (2,840) | NM |
| NASDAQ 100 Total | | 32,792 | 1,169 | (15,024) | 18,937 | -42% | 2,160 | 1,082 | (17,396) | (14,157) | -765% | (59,842) | 1,139 | (17,298) | (75,801) | NM |

*Source: Company reports; FactSet Research Systems Inc.; Standard and Poor's, NASDAQ; Bear Stearns estimates.*

Note: This is an update to the original table published in our March 30, 2004 First Call. In the March 30th First Call we used estimates for several January year-end companies that had not yet released their annual results. The exhibit incorporates the fiscal year-end results for the companies that have since released their 10Ks.



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APPENDIX C: Pro Forma Income From Continuing Operations of the NASDAQ 100 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

Accounting and Taxation Research
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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Consumer Discretionary*** | | | | | | | | | | | | | | | | | |
| ***Auto Components (1)*** | | | | | | | | | | | | | | | | | |
| Gentex Corporation | GNTX | Dec-03 | | 106.8 | - | (10.5) | 96.3 | 1.37 | 1.25 | -10% | 85.8 | - | (8.1) | 77.7 | 1.12 | 1.01 | -9% |
| **Total** | | | | **106.8** | - | **(10.5)** | **96.3** | | | **-10%** | **85.8** | - | **(8.1)** | **77.7** | | | **-9%** |
| ***Hotels Restaurants & Leisure (1)*** | | | | | | | | | | | | | | | | | |
| Starbucks Corp. | SBUX | Sep-03 | | 268.3 | - | (37.4) | 230.9 | 0.67 | 0.58 | -14% | 212.7 | - | (37.4) | 175.2 | 0.54 | 0.44 | -18% |
| **Total** | | | | **268.3** | - | **(37.4)** | **230.9** | | | **-14%** | **212.7** | - | **(37.4)** | **175.2** | | | **-18%** |
| ***Internet & Catalog Retail (1)*** | | | | | | | | | | | | | | | | | |
| eBay Inc. | EBAY | Dec-03 | | 447.2 | 5.5 | (201.8) | 250.9 | 0.68 | 0.38 | -44% | 249.9 | 6.0 | (192.9) | 62.9 | 0.43 | 0.11 | -75% |
| **Total** | | | | **447.2** | **5.5** | **(201.8)** | **250.9** | | | **-44%** | **249.9** | **6.0** | **(192.9)** | **62.9** | | | **-75%** |
| ***Media (2)*** | | | | | | | | | | | | | | | | | |
| Comcast Corp. | CMCSA | Dec-03 | | (218.0) | 10.0 | (172.0) | (380.0) | (0.10) | (0.18) | 74% | (469.0) | 11.0 | (145.0) | (603.0) | (0.42) | (0.54) | 29% |
| Lamar Advertising Company | LAMR | Dec-03 | | (35.2) | - | (3.5) | (38.6) | (0.35) | (0.38) | 10% | (36.3) | - | (6.6) | (42.9) | (0.36) | (0.43) | 18% |
| **Total** | | | | **(253.2)** | **10.0** | **(175.5)** | **(418.6)** | | | **N/M** | **(505.3)** | **11.0** | **(151.6)** | **(645.9)** | | | **N/M** |
| ***Multiline Retail (1)*** | | | | | | | | | | | | | | | | | |
| Dollar Tree Stores, Inc. | DLTR | Jan-04 | | 177.6 | - | (13.2) | 164.4 | 1.54 | 1.43 | -7% | 154.6 | - | (12.6) | 142.0 | 1.35 | 1.24 | -8% |
| **Total** | | | | **177.6** | - | **(13.2)** | **164.4** | | | **-7%** | **154.6** | - | **(12.6)** | **142.0** | | | **-8%** |
| ***Specialty Retail (6)*** | | | | | | | | | | | | | | | | | |
| Amazon.com, Inc. | AMZN | Dec-03 | (b) | 35.5 | 87.8 | (94.5) | 28.5 | 0.08 | 0.07 | -19% | (149.9) | 88.8 | (148.1) | (229.1) | (0.40) | (0.61) | 53% |
| Bed Bath & Beyond Inc. | BBBY | Feb-03 | | 302.2 | - | (25.4) | 276.7 | 1.00 | 0.92 | -8% | 219.6 | - | (19.6) | 200.0 | 0.74 | 0.67 | -9% |
| InterActiveCorp | IACI | Dec-03 | | 126.7 | 75.2 | (151.4) | 50.5 | 0.17 | 0.05 | -60% | 2.0 | 8.2 | (158.1) | (147.9) | (0.04) | (0.39) | -750% |
| PETsMART, Inc. | PETM | Jan-04 | | 88.9 | - | (8.0) | 80.8 | 0.63 | 0.55 | -9% | 39.6 | - | (6.8) | 32.7 | 0.35 | 0.29 | -17% |
| Ross Stores, Inc. | ROST | Jan-04 | | 201.2 | 7.5 | (15.5) | 193.1 | 2.52 | 2.44 | -4% | 155.0 | 7.2 | (13.3) | 149.0 | 1.91 | 1.84 | -4% |
| Staples, Inc. | SPLS | Jan-04 | | 490.2 | - | (40.0) | 450.2 | 0.99 | 0.91 | -8% | 448.1 | - | (35.3) | 412.8 | 0.94 | 0.87 | -7% |
| **Total** | | | | **1,244.4** | **170.4** | **(334.9)** | **1,079.8** | | | **-13%** | **712.4** | **84.3** | **(378.1)** | **417.8** | | | **-41%** |
| ***Consumer Discretionary (12)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **1,991.1** | **185.9** | **(773.3)** | **1,403.7** | | | **-30%** | **910.0** | **101.3** | **(781.8)** | **329.5** | | | **-75%** |
| ***Consumer Staples*** | | | | | | | | | | | | | | | | | |
| ***Food & Staples Retailing (2)*** | | | | | | | | | | | | | | | | | |
| Costco Wholesale Corporation | COST | Aug-03 | Prospective | 721.0 | 7.5 | (70.3) | 658.3 | 1.53 | 1.40 | -9% | 700.0 | - | (75.7) | 624.2 | 1.48 | 1.32 | -11% |
| Whole Foods Market, Inc. | WFMI | Sep-03 | | 103.7 | - | (17.7) | 86.0 | 1.86 | 1.41 | -17% | 84.5 | - | (14.1) | 70.4 | 1.40 | 1.19 | -17% |
| **Total** | | | | **824.7** | **7.5** | **(87.9)** | **744.3** | | | **-10%** | **784.5** | - | **(89.8)** | **694.7** | | | **-11%** |
| ***Consumer Staples (2)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **824.7** | **7.5** | **(87.6)** | **744.3** | | | **-10%** | **784.5** | - | **(89.8)** | **694.7** | | | **-11%** |
| ***Energy*** | | | | | | | | | | | | | | | | | |
| ***Energy Equipment & Services (1)*** | | | | | | | | | | | | | | | | | |
| Pantersar-UTI Energy, Inc. | PTEN | Dec-03 | | 55.8 | - | (10.5) | 45.3 | 0.58 | 0.55 | -10% | 2.2 | - | (5.3) | (3.1) | 0.03 | (0.04) | -244% |
| **Total** | | | | **55.8** | - | **(10.5)** | **45.3** | | | **-10%** | **2.2** | - | **(5.3)** | **(3.1)** | | | **-244%** |
| ***Energy (1)*** | | | | | | | | | | | | | | | | | |
| ***Total*** | | | | **55.8** | - | **(10.5)** | **45.3** | | | **-10%** | **2.2** | - | **(5.3)** | **(3.1)** | | | **-244%** |
| ***Health Care*** | | | | | | | | | | | | | | | | | |
| ***Biotechnology (9)*** | | | | | | | | | | | | | | | | | |
| Amgen Inc. | AMGN | Dec-03 | | 2,259.5 | - | (198.0) | 2,061.5 | 1.69 | 1.55 | -8% | (1,391.9) | - | (189.8) | (1,581.7) | (1.21) | (1.37) | 14% |
| Biogen Idec Inc | BIIB | Dec-03 | | (675.1) | - | (51.9) | (928.8) | (4.92) | (5.21) | 6% | 148.1 | - | (54.7) | 93.4 | 0.85 | 0.54 | -37% |
| Cephalon, Inc. | CEPH | Dec-03 | | 83.9 | - | (33.9) | 50.0 | 1.44 | 0.88 | -40% | 175.1 | - | (34.7) | 140.4 | 2.84 | 2.32 | -20% |
| Chiron Corporation | CHIR | Dec-03 | | 220.3 | 5.6 | (100.8) | 125.1 | 1.15 | 0.65 | -43% | 161.1 | 3.2 | (67.1) | 117.2 | 0.94 | 0.61 | -35% |
| Genzyme General | GENZ | Dec-03 | | (67.6) | 0.4 | (80.0) | (147.3) | 0.42 | 0.08 | 119% | 85.2 | 0.8 | (69.7) | 16.3 | 0.51 | 0.05 | -91% |
| Gilead Sciences, Inc. | GILD | Dec-03 | | (72.0) | 1.2 | (61.4) | (132.2) | (0.38) | (0.66) | 54% | 72.1 | 0.0 | (72.1) | 0.0 | 0.35 | - | -100% |
| Invitrogen Corporation | IVGN | Dec-03 | | 60.1 | 1.0 | (33.8) | 27.4 | 1.17 | 0.53 | -54% | 47.7 | 0.2 | (33.8) | 14.1 | 0.90 | 0.27 | -71% |
| Medimmune, Inc. | MEDI | Dec-03 | | 183.2 | 2.5 | (87.5) | 98.2 | 0.72 | 0.39 | -46% | (1,098.0) | 12.1 | (96.3) | (1,182.2) | (4.40) | (4.74) | 8% |
| Millennium Pharmaceuticals, Inc. | MLNM | Dec-03 | | (483.7) | 2.5 | (66.8) | (550.0) | (1.63) | (1.85) | 14% | (586.2) | 2.5 | (141.0) | (725.6) | (2.13) | (2.62) | 23% |
| **Total** | | | | **1,308.7** | **13.2** | **(718.1)** | **603.7** | | | **-54%** | **(2,379.9)** | **18.9** | **(759.2)** | **(3,111.5)** | | | **N/M** |
| ***Health Care Equipment & Supplies (2)*** | | | | | | | | | | | | | | | | | |
| Biomet, Inc. | BMET | May-03 | | 286.7 | - | (5.5) | 281.2 | 1.10 | 1.08 | -2% | 239.7 | - | (5.3) | 234.5 | 0.88 | 0.86 | -2% |
| DENTSPLY International Inc. | XRAY | Dec-03 | | 169.9 | - | (11.1) | 158.8 | 2.11 | 1.97 | -7% | 143.6 | - | (9.6) | 134.1 | 1.80 | 1.68 | -7% |
| **Total** | | | | **456.6** | - | **(16.6)** | **440.0** | | | **-4%** | **383.4** | - | **(14.8)** | **368.5** | | | **-4%** |



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APPENDIX C: Pro Forma Income From Continuing Operations of the NASDAQ 100 By Sector and Industry Group ($ in Millions)

BEAR STEARNS

Accounting and Taxation Research
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| Company Name | Ticker | Fiscal Yearend | Method of Adoption of the Fair Value Method | 2003: Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included in Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | Reported EPS from Cont. Oper. | Pro Forma EPS from Cont. Oper. | (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002: Reported Net Income/ (Net Loss) from Cont. Oper. | Stock-based Compensation Included in Reported NI from Cont. Oper. | Total Stock-based Compensation | Pro Forma Net Income/ (Net Loss) from Cont. Oper. | Reported EPS from Cont. Oper. | Pro Forma EPS from Cont. Oper. | (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Health Care Providers & Services (5)*** | | | | | | | | | | | | | | | | | |
| Express Scripts, Inc. | ESRX | Dec-03 | | 250.6 | 4.4 | (16.3) | 238.8 | 3.17 | 3.01 | -5% | 202.8 | 5.1 | (16.5) | 191.5 | 2.55 | 2.39 | -6% |
| First Health Group Corp. | FHCC | Dec-03 | | 152.7 | 0.1 | (12.7) | 140.1 | 1.57 | 1.44 | -8% | 132.9 | - | (15.2) | 117.8 | 1.28 | 1.13 | -11% |
| Henry Schein, Inc. | HSIC | Dec-03 | | 139.5 | - | (7.4) | 132.1 | 3.10 | 2.93 | -5% | 118.0 | - | (5.7) | 112.3 | 2.63 | 2.50 | -5% |
| Lincare Holdings Inc. | LNCR | Dec-03 | | 232.1 | - | (17.1) | 215.0 | 2.22 | 2.06 | -7% | 190.4 | - | (18.9) | 171.6 | 1.73 | 1.56 | -10% |
| Patterson Dental Company | PDCO | Apr-03 | | 115.3 | - | (1.5) | 114.8 | 1.70 | 1.68 | -1% | 95.3 | - | (1.1) | 94.2 | 1.40 | 1.39 | -1% |
| Total | | | | 891.3 | 4.5 | (55.9) | 840.9 | | | -6% | 739.5 | 5.1 | (57.3) | 687.3 | | | -7% |
| ***Pharmaceuticals (1)*** | | | | | | | | | | | | | | | | | |
| Teva Pharmaceutical Industries Limited | TEVA | Dec-03 | | 691.0 | 0.5 | (54.7) | 636.8 | 2.39 | 2.21 | -6% | 410.3 | 0.1 | (58.6) | 351.8 | 1.52 | 1.30 | -14% |
| Total | | | | 691.0 | 0.5 | (54.7) | 636.8 | | | -6% | 410.3 | 0.1 | (58.6) | 351.8 | | | -14% |
| ***Health Care (17)*** | | | | | | | | | | | | | | | | | |
| Total | | | | 3,347.5 | 18.2 | (842.4) | 2,523.3 | | | -25% | (837.7) | 24.1 | (889.9) | (1,703.5) | | | N/M |
| ***Industrials*** | | | | | | | | | | | | | | | | | |
| ***Air Freight & Logistics (2)*** | | | | | | | | | | | | | | | | | |
| C.H. Robinson Worldwide, Inc. | CHRW | Dec-03 | | 114.1 | - | (6.8) | 107.4 | 1.33 | 1.25 | -6% | 96.3 | - | (6.5) | 89.8 | 1.12 | 1.05 | -7% |
| Expeditors International of Washington, Inc. | EXPD | Dec-03 | | 122.0 | - | (23.6) | 98.4 | 1.12 | 0.91 | -19% | 112.5 | - | (19.5) | 93.0 | 1.03 | 0.87 | -17% |
| Total | | | | 236.1 | - | (30.3) | 205.8 | | | -13% | 208.8 | - | (26.1) | 182.8 | | | -12% |
| ***Airlines (1)*** | | | | | | | | | | | | | | | | | |
| Ryanair Holdings plc | RYAAY | Mar-03 | | 241.8 | - | (15.1) | 226.7 | 0.31 | 0.29 | -6% | 155.5 | - | (2.2) | 153.3 | 0.20 | 0.20 | -1% |
| Total | | | | 241.8 | - | (15.1) | 226.7 | | | -6% | 155.5 | - | (2.2) | 153.3 | | | -1% |
| ***Commercial Services & Supplies (3)*** | | | | | | | | | | | | | | | | | |
| Apollo Group, Inc. | APOL | Aug-03 | | 247.0 | - | (14.1) | 232.9 | 1.30 | 1.22 | -6% | 161.2 | - | (13.4) | 147.7 | 0.87 | 0.79 | -8% |
| Career Education Corporation | CECO | Dec-03 | | 119.2 | - | (12.4) | 106.7 | 1.19 | 1.08 | -10% | 67.5 | - | (8.8) | 58.7 | 0.71 | 0.62 | -13% |
| Cintas Corporation | CTAS | May-03 | | 249.3 | - | (3.8) | 245.5 | 1.45 | 1.43 | -2% | 234.3 | - | (4.8) | 229.5 | 1.36 | 1.33 | -2% |
| Total | | | | 615.4 | - | (30.4) | 585.1 | | | -5% | 462.9 | - | (27.0) | 435.9 | | | -6% |
| ***Electrical Equipment (1)*** | | | | | | | | | | | | | | | | | |
| American Power Conversion Corporation | APCC | Dec-03 | | 176.9 | - | (23.2) | 153.8 | 0.88 | 0.76 | -13% | 116.5 | - | (25.1) | 91.4 | 0.59 | 0.46 | -22% |
| Total | | | | 176.9 | - | (23.2) | 153.8 | | | -13% | 116.5 | - | (25.1) | 91.4 | | | -22% |
| ***Machinery (1)*** | | | | | | | | | | | | | | | | | |
| PACCAR Inc. | PCAR | Dec-03 | Prospective | 526.5 | 1.7 | (4.7) | 523.5 | 2.89 | 2.87 | -1% | 372.0 | - | (5.5) | 366.5 | 2.13 | 2.10 | -1% |
| Total | | | | 526.5 | 1.7 | (4.7) | 523.5 | | | -1% | 372.0 | - | (5.5) | 366.5 | | | -1% |
| ***Trading Companies & Distributors (1)*** | | | | | | | | | | | | | | | | | |
| Fastenal Company | FAST | Dec-03 | | 84.1 | - | (1.8) | 82.4 | 1.11 | 1.09 | -2% | 75.5 | - | (2.7) | 72.9 | 1.00 | 0.96 | -4% |
| Total | | | | 84.1 | - | (1.8) | 82.4 | | | -2% | 75.5 | - | (2.7) | 72.9 | | | -4% |
| ***Industrials (9)*** | | | | | | | | | | | | | | | | | |
| Total | | | | 1,880.9 | 1.7 | (105.4) | 1,777.2 | | | -6% | 1,391.3 | - | (88.6) | 1,302.7 | | | -6% |
| ***Information Technology*** | | | | | | | | | | | | | | | | | |
| ***Communications Equipment (11)*** | | | | | | | | | | | | | | | | | |
| Cisco Systems, Inc. | CSCO | Jul-03 | | 3,578.0 | - | (1,259.0) | 2,319.0 | 0.50 | 0.32 | -35% | 1,893.0 | - | (1,520.0) | 373.0 | 0.25 | 0.05 | -80% |
| Comverse Technology, Inc. | CMVT | Jan-03 | | (5.4) | - | (132.5) | (137.9) | (0.03) | (0.89) | 2831% | (129.5) | - | (149.8) | (279.3) | (0.89) | (1.49) | 116% |
| EchoStar Communications Corporation | DISH | Dec-03 | | 224.5 | 3.4 | (26.1) | 201.8 | 0.46 | 0.41 | -10% | (832.0) | 10.9 | (24.4) | (865.5) | (0.86) | (0.89) | 2% |
| Garmin Ltd. | GRMN | Dec-03 | | 176.6 | - | (3.0) | 173.6 | 1.64 | 1.60 | -2% | 142.8 | - | (1.9) | 140.9 | 1.32 | 1.30 | -1% |
| JDS Uniphase Corporation | JDSU | Jun-03 | | (933.8) | 50.9 | (685.2) | (1,568.1) | (0.56) | (1.10) | 96% | (8,738.3) | 124.9 | (689.9) | (9,302.3) | (6.50) | (6.50) | 0% |
| Juniper Networks, Inc. | JNPR | Dec-03 | | 39.2 | 1.3 | (60.3) | (19.9) | 0.10 | (0.05) | -151% | (119.7) | 0.3 | (91.0) | (210.4) | (0.34) | (0.60) | 76% |
| Level 3 Communications, Inc. | LVLT | Dec-03 | Prospective (a) | (721.0) | 51.6 | (51.8) | (721.0) | (1.28) | (1.28) | 0% | (880.0) | 108.6 | (108.6) | (880.0) | (2.11) | (2.11) | 0% |
| QLogic Corporation | QLGC | Mar-03 | | 103.5 | 1.2 | (37.8) | 67.1 | 1.09 | 0.70 | -35% | 70.7 | 1.4 | (30.0) | 42.1 | 0.74 | 0.44 | -40% |
| QUALCOMM Incorporated | QCOM | Sep-03 | | 827.4 | 0.8 | (260.4) | 567.7 | 1.01 | 0.69 | -31% | 359.7 | 1.3 | (235.2) | 125.8 | 0.44 | 0.16 | -64% |
| Research in Motion Limited | RIMM | Feb-03 | | (146.7) | - | (20.3) | (169.0) | (1.51) | (2.17) | 14% | (28.5) | - | (19.8) | (48.3) | (0.36) | (0.61) | 69% |
| Tellabs, Inc. | TLAB | Dec-03 | | (241.6) | 11.2 | (62.5) | (293.0) | (0.59) | (0.71) | 21% | (313.1) | 16.5 | (129.6) | (426.2) | (0.76) | (1.05) | 39% |
| Total | | | | 2,900.8 | 120.3 | (2,418.7) | 402.4 | | | -86% | (8,574.8) | 257.8 | (2,899.2) | (11,316.2) | | | N/M |
| ***Computers & Peripherals (6)*** | | | | | | | | | | | | | | | | | |
| Apple Computer, Inc. | AAPL | Sep-03 | | 68.0 | 15.0 | (181.0) | (98.0) | 0.19 | (0.27) | -244% | 55.0 | 5.0 | (234.0) | (164.0) | 0.18 | (0.45) | -352% |
| ATI Technologies Inc. | ATYT | Aug-03 | | 12.2 | 25.5 | (16.7) | 21.0 | 0.05 | 0.09 | 72% | (47.8) | (1.0) | (17.0) | (65.8) | (0.20) | (0.28) | 38% |
| Dell Inc. | DELL | Jan-03 | | 2,545.0 | - | (794.0) | 1,851.0 | 1.01 | 0.71 | -30% | 2,122.0 | - | (723.0) | 1,399.0 | 0.80 | 0.51 | -34% |
| Network Appliance, Inc. | NTAP | Apr-03 | | 76.5 | 1.2 | (173.7) | (96.0) | 0.22 | (0.28) | -225% | 3.6 | 2.5 | (264.9) | (258.4) | 0.01 | (0.78) | -8631% |
| SanDisk Corporation | SNDK | Dec-03 | | 168.9 | - | (29.8) | 139.1 | 1.03 | 0.84 | -18% | 36.2 | - | (23.0) | 13.3 | 0.25 | 0.10 | -63% |
| Sun Microsystems, Inc. | SUNW | Jun-03 | | (3,429.0) | 23.0 | (578.0) | (3,984.0) | (1.07) | (1.25) | 16% | (587.0) | 33.0 | (660.0) | (1,234.0) | (0.18) | (0.36) | 110% |
| Total | | | | (408.5) | 64.7 | (1,773.3) | (2,167.1) | | | N/M | 1,581.5 | 39.5 | (1,941.9) | (319.9) | | | -120% |
| ***Electronic Equipment & Instruments (4)*** | | | | | | | | | | | | | | | | | |
| CDW Corporation | CDWC | Dec-03 | | 175.2 | 0.3 | (24.7) | 150.8 | 2.05 | 1.75 | -14% | 185.2 | 0.8 | (26.1) | 159.8 | 2.10 | 1.81 | -14% |
| Flextronics International Ltd. | FLEX | Mar-03 | | (83.5) | - | (56.3) | (139.7) | (0.16) | (0.27) | 67% | (153.7) | - | (67.2) | (220.9) | (0.31) | (0.45) | 44% |
| Molex Incorporated | MOLX | Jun-03 | | 85.3 | 9.9 | (17.4) | 77.8 | 0.44 | 0.40 | -9% | 76.5 | 9.1 | (14.8) | 70.8 | 0.39 | 0.36 | -7% |
| Sanmina-SCI Corporation | SANM | Sep-03 | | (137.2) | 1.7 | (55.4) | (190.9) | (0.27) | (0.37) | 39% | (2,696.9) | - | (66.9) | (2,763.7) | (5.60) | (5.73) | 2% |
| Total | | | | 39.9 | 12.0 | (153.8) | (101.9) | | | -355% | (2,588.7) | 9.9 | (175.1) | (2,754.3) | | | N/M |



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**APPENDIX C: Pro Forma Income From Continuing Operations of the NASDAQ 100 By Sector and Industry Group ($ in Millions)**

BEAR
STEARNS

**Accounting and Taxation Research**
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| Company Name | Ticker | Fiscal Yeaend | Method of Adoption of the Fair Value Method | 2003 Reported Net Income/ (Net Loss) from Cont. Oper. | 2003 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2003 Total Stock-based Compensation | 2003 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2003 Reported EPS from Cont. Oper. | 2003 Pro Forma EPS from Cont. Oper. | 2003 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. | 2002 Reported Net Income/ (Net Loss) from Cont. Oper. | 2002 Stock-based Compensation Included in Reported NI from Cont. Oper. | 2002 Total Stock-based Compensation | 2002 Pro Forma Net Income/ (Net Loss) from Cont. Oper. | 2002 Reported EPS from Cont. Oper. | 2002 Pro Forma EPS from Cont. Oper. | 2002 (Decrease in Net Income) / Increase in Net Loss from Cont. Oper. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Internet Software & Services (1)*** | | | | | | | | | | | | | | | | | |
| Yahoo Inc. | YHOO | Dec-03 | | 237.9 | 13.0 | (216.0) | 34.8 | 0.37 | 0.05 | -85% | 106.9 | 5.0 | (488.0) | (376.0) | 0.18 | (0.63) | -452% |
| **Total** | | | | **237.9** | **13.0** | **(216.0)** | **34.8** | | | **-85%** | **106.9** | **5.0** | **(488.0)** | **(376.0)** | | | **-453%** |
| ***IT Services (2)*** | | | | | | | | | | | | | | | | | |
| Fiserv, Inc. | FISV | Dec-03 | | 315.0 | - | (17.3) | 298.0 | 1.61 | 1.52 | -5% | 296.1 | - | (18.2) | 247.9 | 1.37 | 1.27 | -7% |
| Paychex, Inc. | PAYX | May-03 | | 293.8 | - | (10.5) | 283.5 | 0.78 | 0.75 | -3% | 274.5 | - | (12.6) | 261.9 | 0.73 | 0.69 | -5% |
| **Total** | | | | **608.8** | **-** | **(27.8)** | **581.5** | | | **-4%** | **570.6** | | **(30.8)** | **509.8** | | | **-6%** |
| ***Semiconductor & Semiconductor Equipment (14)*** | | | | | | | | | | | | | | | | | |
| Altera Corporation | ALTR | Dec-03 | | 155.1 | 7.6 | (94.0) | 68.7 | 0.40 | 0.18 | -56% | 91.3 | 8.2 | (96.4) | 3.0 | 0.23 | 0.01 | -97% |
| Applied Materials, Inc. | AMAT | Oct-03 | | (149.1) | - | (389.1) | (538.2) | (0.09) | (0.32) | 261% | 289.0 | - | (316.7) | (47.7) | 0.16 | (0.03) | -118% |
| Broadcom Corporation | BRCM | Dec-03 | | (909.9) | 577.5 | (1,005.9) | (1,408.3) | (3.29) | (4.82) | 47% | (2,236.9) | 419.7 | (1,668.7) | (2,585.2) | (8.35) | (10.77) | 29% |
| Intel Corporation | INTC | Dec-03 | | 3,641.0 | - | (991.0) | 4,650.0 | 0.85 | 0.71 | -16% | 3,117.0 | - | (1,170.0) | 1,947.0 | 0.48 | 0.29 | -38% |
| Intersil Corporation | ISIL | Dec-03 | | 58.5 | 23.7 | (52.8) | 61.7 | 0.41 | (0.21) | -151% | (23.3) | 15.3 | (58.4) | (66.4) | (0.18) | (0.53) | -185% |
| KLA-Tencor Corporation | KLAC | Jun-03 | | 137.2 | - | (90.9) | 46.3 | 0.70 | 0.24 | -66% | 216.2 | - | (123.8) | 92.4 | 1.10 | 0.47 | -57% |
| Lam Research Corporation | LRCX | Jun-03 | | (1.7) | 0.6 | (43.2) | (50.3) | (0.00) | (0.40) | 551% | (30.1) | 1.7 | (34.5) | (122.9) | (0.71) | (0.97) | 36% |
| Linear Technology Corporation | LLTC | Jun-03 | | 236.8 | - | (75.9) | 160.7 | 0.74 | 0.50 | -32% | 197.6 | - | (65.7) | 131.9 | 0.60 | 0.40 | -33% |
| Marvell Technology Group, Ltd. | MRVL | Jan-04 | | (72.2) | 7.5 | (77.5) | (142.0) | (0.61) | (1.20) | 98% | (415.2) | 15.0 | (67.7) | (467.9) | (3.63) | (4.09) | 13% |
| Maxim Integrated Products, Inc. | MXIM | Jun-03 | | 309.6 | - | (129.7) | 163.9 | 0.91 | 0.50 | -45% | 258.2 | - | (171.7) | 87.5 | 0.73 | 0.25 | -66% |
| Microchip Technology Incorporated | MCHP | Mar-03 | | 99.7 | - | (36.2) | 63.5 | 0.47 | 0.30 | -36% | 94.5 | - | (29.4) | 65.4 | 0.45 | 0.31 | -31% |
| Novellus Systems, Inc. | NVLS | Dec-03 | | (5.0) | 2.2 | (66.1) | (68.9) | (0.03) | (0.46) | 1269% | 22.9 | 1.2 | (70.2) | (46.1) | 0.15 | (0.32) | -301% |
| NVIDIA Corporation | NVDA | Jan-04 | | 74.4 | 0.5 | (74.5) | 0.4 | 0.43 | - | -99% | 90.8 | 37.3 | (205.4) | (77.3) | 0.54 | (0.50) | -185% |
| Xilinx, Inc. | XLNX | Mar-03 | | 125.7 | - | (114.3) | 11.4 | 0.36 | 0.03 | -91% | (113.8) | - | (114.3) | (227.9) | (0.34) | (0.68) | 101% |
| **Total** | | | | **5,643.2** | **615.0** | **(3,301.6)** | **2,961.6** | | | **-48%** | **1,480.1** | **498.4** | **(3,592.8)** | **(1,614.1)** | | | **-209%** |
| ***Software (17)*** | | | | | | | | | | | | | | | | | |
| Adobe Systems Incorporated | ADBE | Nov-03 | | 266.3 | 1.8 | (188.4) | 79.8 | 1.10 | 0.33 | -70% | 191.4 | 4.4 | (189.2) | 6.6 | 0.79 | 0.03 | -97% |
| BEA Systems, Inc. | BEAS | Jan-04 | | 83.9 | 4.5 | (154.2) | (65.8) | 0.20 | (0.18) | -179% | (35.7) | 1.1 | (202.2) | (236.9) | (0.09) | (0.60) | 564% |
| Check Point Software Technologies Ltd. | CHKP | Dec-03 | | 243.9 | - | (37.3) | 206.6 | 0.96 | 0.82 | -15% | 255.1 | - | (61.5) | 193.6 | 1.00 | 0.76 | -24% |
| Citrix Systems, Inc. | CTXS | Dec-03 | | 126.9 | - | (87.6) | 39.3 | 0.74 | 0.23 | -69% | 83.9 | - | (137.6) | (43.7) | 0.52 | (0.25) | -147% |
| Compuware Corporation | CPWR | Mar-03 | | 103.1 | - | (31.9) | 71.2 | 0.27 | 0.14 | -50% | (240.3) | - | (61.5) | (307.2) | (0.66) | (0.83) | 25% |
| Electronic Arts Inc. | ERTS | Mar-03 | | 317.1 | - | (83.9) | 233.2 | 2.17 | 1.62 | -26% | 101.5 | - | (73.6) | 27.9 | 0.71 | 0.20 | -73% |
| Intuit Inc. | INTU | Jul-03 | | 263.2 | 0.8 | (84.4) | 179.6 | 1.25 | 0.85 | -32% | 53.6 | 0.2 | (94.7) | (35.9) | 0.24 | (0.17) | -167% |
| Mercury Interactive Corporation | MERQ | Dec-03 | | 41.5 | 5.9 | (141.7) | (94.3) | 0.45 | (1.08) | -327% | 65.2 | 1.2 | (122.2) | (55.8) | 0.74 | (0.67) | -196% |
| Microsoft Corporation | MSFT | Jun-03 | Retroactive Restatement | 9,993.0 | 52.0 | (2,514.0) | 7,531.0 | 0.92 | 0.69 | -25% | 7,829.0 | 99.0 | (2,573.0) | 5,355.0 | 0.70 | 0.48 | -32% |
| Oracle Corporation | ORCL | May-03 | | 2,307.0 | - | (330.0) | 1,977.0 | 0.43 | 0.38 | -14% | 2,224.0 | - | (450.0) | 1,774.0 | 0.39 | 0.31 | -21% |
| PeopleSoft, Inc. | PSFT | Dec-03 | | 85.0 | 10.5 | (171.0) | (75.5) | 0.35 | (0.22) | -163% | 182.8 | 6.8 | (188.4) | (5.7) | 0.57 | (0.03) | -108% |
| Pixar | PIXR | Dec-03 | | 124.8 | - | (16.9) | 107.9 | 2.17 | 1.83 | -14% | 90.0 | - | (13.2) | 76.8 | 1.68 | 1.49 | -15% |
| Siebel Systems, Inc. | SEBL | Dec-03 | | (3.4) | - | (449.1) | (452.5) | (0.01) | (0.82) | 13223% | (35.7) | - | (1,646.2) | (1,681.9) | (0.08) | (2.27) | 2930% |
| Symantec Corporation | SYMC | Mar-03 | | 246.4 | 0.3 | (89.0) | 159.7 | 1.54 | 1.00 | -36% | (28.2) | - | (79.1) | (107.3) | (0.20) | (0.75) | 281% |
| Synopsys, Inc. | SNPS | Oct-03 | | 149.7 | 5.0 | (99.5) | 55.2 | 0.95 | 0.36 | -63% | (200.0) | 1.5 | (86.0) | (284.4) | (1.60) | (2.13) | -42% |
| Veritas, Inc. | VRSN | Dec-03 | | (259.9) | 7.4 | (223.3) | (475.6) | (1.08) | (1.98) | 83% | (4,561.3) | 19.0 | (246.7) | (5,193.1) | (20.97) | (21.81) | 4% |
| VERITAS Software Corporation | VRTSE | Dec-03 | | - | - | - | - | | | NM | 57.4 | - | (294.6) | (237.4) | 0.14 | (0.58) | -514% |
| **Total** | | | | **14,890.7** | **88.1** | **(4,732.2)** | **9,446.6** | | | **-33%** | **5,837.6** | **138.1** | **(9,934.4)** | **(158.7)** | | | **-103%** |
| ***Information Technology (55)*** | | | | | | | | | | | | | | | | | |
| **Total** | | | | **23,063.0** | **917.6** | **(12,912.4)** | **11,168.1** | | | **-52%** | **(1,806.8)** | **948.5** | **(18,161.9)** | **(16,020.1)** | | | **NM** |
| ***Materials*** | | | | | | | | | | | | | | | | | |
| ***Chemicals (1)*** | | | | | | | | | | | | | | | | | |
| Sigma-Aldrich | SIAL | Dec-03 | | 190.4 | - | (11.1) | 179.3 | 2.88 | 2.53 | -4% | 186.7 | - | (10.0) | 176.8 | 2.54 | 2.40 | -5% |
| **Total** | | | | **190.4** | **-** | **(11.1)** | **179.3** | | | **-4%** | **186.7** | **-** | **(10.0)** | **176.8** | | | **-5%** |
| ***Containers & Packaging (1)*** | | | | | | | | | | | | | | | | | |
| Smurfit-Stone Container Corporation | SSCC | Dec-03 | Prospective | (198.0) | 2.0 | (12.0) | (208.0) | (0.85) | (0.85) | 5% | 59.0 | - | (13.0) | 46.0 | 0.20 | 0.15 | -22% |
| **Total** | | | | **(198.0)** | **2.0** | **(12.0)** | **(208.0)** | | | **N/M** | **59.0** | **-** | **(13.0)** | **46.0** | | | **-22%** |
| ***Materials (2)*** | | | | | | | | | | | | | | | | | |
| **Total** | | | | **(7.8)** | **2.0** | **(23.1)** | **(28.7)** | | | **N/M** | **245.7** | **-** | **(23.0)** | **222.8** | | | **-9%** |
| ***Telecommunication Services*** | | | | | | | | | | | | | | | | | |
| ***Diversified Telecommunication Services (1)*** | | | | | | | | | | | | | | | | | |
| PanAmSat Corporation | SPOT | Dec-03 | Prospective | 99.5 | 1.2 | (8.9) | 91.8 | 0.66 | 0.61 | -8% | 85.0 | - | (9.2) | 75.9 | 0.57 | 0.51 | -11% |
| **Total** | | | | **99.5** | **1.2** | **(8.9)** | **91.8** | | | **-8%** | **85.0** | **-** | **(9.2)** | **75.9** | | | **-11%** |
| ***Wireless Telecommunication Services (1)*** | | | | | | | | | | | | | | | | | |
| Nextel Communications, Inc. | NXTL | Dec-03 | | 1,537.0 | 35.0 | (360.0) | 1,212.0 | 1.36 | 1.07 | -21% | 1,386.0 | 8.0 | (350.0) | 1,044.0 | 1.78 | 1.43 | -20% |
| **Total** | | | | **1,537.0** | **35.0** | **(360.0)** | **1,212.0** | | | **-21%** | **1,386.0** | **8.0** | **(350.0)** | **1,044.0** | | | **-20%** |
| ***Telecommunication Services (3)*** | | | | | | | | | | | | | | | | | |
| **Total** | | | | **1,636.5** | **36.2** | **(368.9)** | **1,303.5** | | | **-20%** | **1,471.0** | **8.0** | **(359.2)** | **1,119.8** | | | **-24%** |

*Source: Company reports, FactSet Research Systems Inc., Standard and Poor's, NASDAQ; Bear Stearns estimates*

The NASDAQ 100 as of March 19, 2004

N/A Not available.
N/M Not meaningful.

(a) The company adopted FAS No. 123 before the issuance of FAS No. 148, therefore, the prospective method was the only method of adoption available to the company.
(b) In a July 22, 2002 press release, Amazon stated that "The Company announced that by the beginning of 2003 all stock-based awards granted thereafter will be expensed." To date, the company has not formally adopted the fair value method. The company has not granted any options in 2003. It has used other compensation methods such as restricted stock which are expensed regardless of whether a company adopts the fair value method for stock option grants.



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**ANALYST CERTIFICATION**
The Research Analyst(s) who prepared the research report hereby certify that the views expressed in this research report accurately reflect the analyst(s) personal views about the subject companies and their securities. The Research Analyst(s) also certify that the Analyst(s) have not been, are not, and will not be receiving direct or indirect compensation for expressing the specific recommendation(s) or view(s) in this report.
Pat McConnell/Janet Pegg

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**IMPORTANT DISCLOSURES**

**Bear, Stearns & Co. Equity Research Rating System:**
**Ratings for Stocks (vs. analyst coverage universe):**
**Outperform (O) - Stock is projected to outperform analyst's industry coverage universe over the next 12 months.**
**Peer Perform (P) - Stock is projected to perform approximately in line with analyst's industry coverage universe over the next 12 months.**
**Underperform (U) - Stock is projected to underperform analyst's industry coverage universe over the next 12 months.**

**Ratings for Sectors (vs. regional broader market index):**
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Mr. STEARNS. Mr. Shadegg.

Mr. SHADEGG. Thank you very much, Mr. Chairman. I apologize, I have very little time. I would like to ask you to keep your answers brief if you possibly could. Mr. Walker, in the other committee that considered this legislation, a witness from CBO came and testified. They were supportive of the FASB rule. I asked him a question kind of following along Mr. White's question, which was in your study did you study the economic impact on the economy; that is, the impact on the economy of this rule? Actually I asked him what factors did he look at and what did it show. He responded that in point of fact in its study CBO had not looked at the impact on the economy, they had simply looked at how the process could be done.

To my knowledge, GAO has not done a study of the impact on the economy of enacting the FASB rule, has it?

Mr. WALKER. No, we haven't. It is my understanding CBO did look at the impact on competitiveness, though, and said it would not have an adverse impact on the competitiveness of U.S. companies.

Mr. SHADEGG. That is not what he said. I asked him what factors they looked at and he said they had not.

Mr. WALKER. They are different issues. You are correct, he did not look at the other.

Mr. SHADEGG. Mr. Herz, would you agree with me that this is a gray issue; that is to say, that it is not clear and black and white and it is not an issue where every logical viewer of the issue would say yes, we should move to expensing stock options?

Mr. HERZ. I think any knowledgeable person in economics and accounting would agree.

Mr. SHADEGG. I am troubled by that.

Mr. HERZ. I think you can debate which method. That is a debate, a vigorous debate we have had at the Board.

Mr. SHADEGG. I think you are interested in where I am going so let me go there. You have pointed out that all the major accounting firms are now on the side of expensing and you have said you are on the side of expensing but just a few brief years ago in December 1993, your name appeared on a letter by Coopers & Lybrand saying that using stock option pricing models would result in unreliable information and would have an adverse impact on the comparability and usefulness of financial statements.

Your name appeared on that letter. I presume you supported that position then. So I guess all of the consensus that you say everybody now, anybody knowledgeable now, would say absolutely should expense. So that letter was not only wrong 7 or 10 years ago, it was dramatically wrong?

Mr. HERZ. That is not a letter. It is a thing called a data line to the practice. All it did was explain people's views.

Mr. SHADEGG. They seemed to be pretty strong views. They say point blank using option pricing models results in unreliable information and would have an adverse impact on the comparability and usefulness of financial statements. Those are pretty strong words.

Mr. HERZ. As I said, that thing expressed people's views, reported people's views, my personal views. I can say that since that time I have studied this issue for many, many, many years.

Mr. SHADEGG. And changed your opinion?

Mr. HERZ. I don't think I had that opinion at that time.

Mr. SHADEGG. Your name and phone number appeared on the letter.

Mr. HERZ. It says for more information on this subject, please contact one of the following three people.

Mr. SHADEGG. You put your name and phone number on a letter that says for more information when you disagreed with the letter?

Mr. HERZ. The letter was a report on views. It was not people's views.

Mr. SHADEGG. Mr. White, let me ask you, the chairman read a pretty lengthy list of people who have said that they think we should move to expensing. I note that all of those people that he recited represent large, well-established companies. None of them, I believe, have made their fortune in startups and quite frankly I noticed a stark absence of anybody in the high tech field or the biotech field. I guess I would like to give you an opportunity to tell me the perspective of startups and the perspective of biotechs and high techs on this issue and the concern of those companies.

Mr. WHITE. I appreciate that. Actually what I would like to do is just read a list of other people who actually don't think that expensing is appropriate. There is a long list, but a couple you might consider are Commissioner Paul Atkins from the SEC. He disagrees with that. Glen Hubbard, formerly at the White House. Larry Lindsey, formerly at the White House, also doesn't agree that expensing is appropriate. Some of you may remember the Honorable Tom Campbell, who was a great Member of this institution, now the Dean of the Business School at Berkeley, he doesn't agree with the comments that have been expressed.

As I think Congressman Shadegg pointed out, there are professors at Harvard, Princeton, Rutgers, Berkeley, Stanford and many, many other schools across the country who disagree with that. I think there has been an effort to suggest that this is a closed issue by people who really understand it, and I think that is absolutely false. There is a real, legitimate, principled debate in accounting as to whether this should be booked as an expense at all.

Mr. SHADEGG. My time is going to run out, Mr. Mayer, but let me ask you in conclusion, one of the things that troubles me with the concept of expensing is that there is in fact not agreement on a correct method of expensing, so much so that FASB itself doesn't propose to dictate a method for expensing. I guess I would like you to explore that as a concern, and there has been reference on the other side to the idea that this proposal, expensing stock options, would have precluded the Enron scandals and other recent scandals. My memory tells me those were not the abuses. As a matter of fact, with regard to some of those I think they were special entities where those companies spun off all of their losses, not showing those losses on their books, which would not in any way have been improved or given a better picture or been avoided if we had had this rule.

I appreciate your comments.

Mr. MAYER. Certainly the method of estimate is one of the great concerns that all of us have in the implementation of this plan. The Black-Scholes method is one that people do understand, although we also understand the drawbacks of it. The lattice model is a model that no one understands. One thing that has not been addressed is how these will be audited. The lattice model would require us to make quarterly estimates of employee behavior going forward 7 to 10 years, of stock market volatility going forward 10 years, and other factors that would all get rolled into this model. By rough calculation for our company, we would have to make several tens if not hundreds of thousands of calculations each quarter, and how those will be audited I don't think anyone has yet addressed.

As far as the question of the recent corporate scandals, I am not a real student of those. However, it is my understanding that stock option accounting has not played a role in any of those.

I have to take issue with a couple of people who have said that this current method prevents investors from making informed decisions. The current SEC disclosure is very clear and very fully informs in footnotes of financial statements all of the information that someone could want and in fact even the CBO report that has been referenced says that this information is already available to investors in the notes to firm's financial reports. So the information is there. This has nothing to do with cash-flows. It is merely a different type of accounting treatment from the one that has been in place for I think some 25 years.

Mr. SHADEGG. Thank you very much. My time has expired. I thank the Chair for indulging me.

Mr. STEARNS. I recognize Ranking Member Dingell.

Mr. DINGELL. Mr. Chairman, I find myself very interested in the thesis that this legislation would require that no longer would corporations that have chosen the method of using fair valuation of options be able to use those.

Can you explain, Mr. White, or perhaps, Mr. Mayer, why we should ban General Motors or any of the other U.S. corporations who have decided they want to use this mechanism from using it?

Mr. WHITE. We shouldn't. I agree. As I understand the bill, it doesn't do that.

Mr. DINGELL. It does do that. Mr. Mayer?

Mr. MAYER. I agree we should not, and it is also my understanding that the bill does not do that.

Mr. DINGELL. I find myself very interested, also, in the fact that the bill says that there would be no—that it would be presumed there would be no volatility in the stock. That is a curious thing. Doesn't that fly in the face of all of our experiences with the indexes? Most recently, for example, the Dow has gone from something like 8,000 to 10,000 and it moves somewhere around 100 or so points a day. That seems to be at variance with fact, does it not, gentlemen?

Mr. WHITE. It flows out of the great complexity of this and the inaccuracy of trying to estimate the value of these things on the date of grant. It is a little like predicting the value of your stock into the future, which is a very difficult thing to do. The problem is with volatility a very small change in your assumptions about

volatility drives a huge change in the valuation, and so it makes it very subject to manipulation. It is the biggest area of inaccuracy in the whole process.

Mr. DINGELL. But to assume that there is no volatility affords people to do some rather innovative accounting, doesn't it? And it would enable us to see people who had this particular responsibility to in fact manipulate the stocks because they could assume there is no volatility. For example, when the bottom fell out of AOL or when the bottom fell out of Tyco, they could assume there is no shift in the value of the stock.

Mr. MAYER. Actually I think quite the opposite. By having zero volatility you stabilize the basis on which these calculations are done. That eliminates a huge variable and in fact the most sensitive variable to the calculation. If you allow people or require people to guesstimate or estimate volatility going forward, that estimate is going to be always changing and that is where games will be played.

Mr. DINGELL. So we have then an assumption that there will be no volatility in stock. That is a bad assumption, is it not?

Mr. MAYER. I think it is a——

Mr. DINGELL. It may be inconvenient that there is this volatility but it is still there, isn't it?

Mr. WHITE. It just points out the futility of this whole exercise. You can't get this number right, and so the effort to make it zero is to stabilize it so it is not quite as wrong as it otherwise would be. That is really the problem.

Mr. DINGELL. Thank you.

Mr. Herz and Mr. Walker, would I be fair in assuming that all accounting was absolute and was done on absolute numbers? Or do we find that there are a lot of estimates that occur in the accounting process?

Mr. WALKER. There are a lot of estimates that occur in the accounting process. Let me give you another one that was controversial. Health care costs, inflation. There was a huge controversy over accounting for post-employment health benefits because of the difficulty in trying to project what the estimated total cost of health care would be, but in the end FASB came up with a clear, consistent and transparent accounting treatment despite that fact.

Mr. DINGELL. I note here that the prohibition on using the fair value of stock options would affect large numbers of U.S. corporations. This question is to Mr. Herz and Mr. Walker. It would affect foreign corporations listing on the U.S. market functioning under international accounting standards, would it not?

Mr. HERZ. Yes. I am not a lawyer but the way I read the——

Mr. DINGELL. It would also affect U.S. subsidiaries of foreign corporations and foreign subsidiaries of U.S. corporations, would it not?

Mr. HERZ. It would affect anybody who doesn't use the method prescribed by the bill.

Mr. DINGELL. So it would ban large numbers of U.S. corporations and foreign companies from being properly listed on the securities exchange, would it not?

Mr. HERZ. It would make them undo what they believe is the better accounting.

Mr. DINGELL. If you can't get your reports approved by the SEC, you can't list, and all of a sudden you have got real problems under our securities laws.

I have been looking here at this business of only the top five. This question is to Mr. White and Mr. Mayer. Why would we limit it to only the top five?

Mr. WHITE. I think there are two reasons. One of them is more of a policy-oriented reason. That is what a lot of people are really concerned about, making sure that executive compensation doesn't get out of the control. I think the reason that is more related to this exercise is that those people are the ones who have the possibility of manipulating the stock price so that it artificially would go up.

Mr. DINGELL. Let's take your assumption. Let's just talk about Enron, which is always a nice subject of discussion. The top Enron executives. All of the above were indicted, Ken Lay, Jeff Skilling, Andrew Fastow, Richard Causey. These are the chairman, chief executive officer, chief financial officer and chief accounting officer. The only one not indicted was Mr. Jeff McMahon, who was the treasurer. I suspect in part because he cut a deal with the U.S. Attorney.

As we go on down we find Lea Fastow was also indicted, Michael Kopper, who was in the treasurer's office and Ben Glisan. There were a goodly number of others. You would get the top five but you wouldn't get the others, so you wouldn't know who was stealing there and who was manipulating the value of stock options or how this impacted upon the value of the shares of stock of the ordinary citizen.

Mr. WHITE. And we wouldn't know under this deal either.

Mr. DINGELL. Are you advocating that we should take that course of action?

Mr. WHITE. No. In fact, the real problem here, and I will let Mr. Mayer respond also, but Enron is an example of where they, as far as people can tell, complied with a lot of accounting standards and still defrauded people. No matter what we do in terms of accounting, if people are going to lie and break the laws, the rules are not going to change that.

Mr. DINGELL. And your prohibition would make it easier?

Mr. WHITE. I don't think so.

Mr. MAYER. I disagree. The value of stock options was not an issue of all the many issues in the Enron situation.

Mr. DINGELL. Stock options were a major inducement because what was done was to keep up the value of stock to keep the value of the stock options up.

Mr. MAYER. And that stock option position was fully disclosed for Enron like all companies who are SEC reporting companies.

Mr. DINGELL. This would require that only the top five be disclosed. I have mentioned you will find five of those who are would-be felons here.

Mr. MAYER. This is talking about expensing the top five, not disclosing. Currently all options are disclosed in the statements, in the notes to the financial statements. Every single option is currently disclosed——

Mr. DINGELL. You would say then that the options either should not be disclosed or that the value of the options should not be disclosed? Which?

Mr. MAYER. No, I think they should absolutely be disclosed and should be fully disclosed, but not expensed on the income statement.

Mr. DINGELL. Mr. Herz, you and Mr. Walker may be able to help us out of this thicket.

Mr. HERZ. My recollection as I watched a lot of these hearings on TV was that Mr. Skilling actually testified that he used stock options as a way to inflate earnings. In fact, he basically accused you in Congress for allowing that to go on, having overridden the FASB, so to speak, the last time around.

Mr. DINGELL. How then would this five-person exemption or this five-person requirement impact on the way honest reporting was done?

Mr. HERZ. Honest reporting looks at the same transaction, whether it be given to the top person or the 800th person. This is like saying that only the top five salaries ought to be expensed, the top five pensions, let's just show the five top pieces of debt to the company. There is no consistency or coherence to the financial statements once you go down that path.

Mr. DINGELL. I would just note here that Mr. Skilling admitted the benefits of this substitution in effect during his congressional testimony. He said as follows: "You issue stock options to reduce compensation expense and therefore increase your profitability."

What is the amount of some of the corporate salaries in some of these people that would be exempted? It would run to millions or even hundreds of millions of dollars a year, would it not?

Mr. STEARNS. The time of the gentleman has expired, but I certainly will allow——

Mr. DINGELL. Just that one question, Mr. Chairman. I thank you for the very great courtesy you have given me.

Mr. HERZ. The amount for individual CEOs can be very large, but I think from our point of view the issue is that not expensing it for the rest of the people leaves out a big element of compensation and of cost from the financial statements. In the case of certain major high tech companies, that can run into billions of dollars.

Mr. DINGELL. Mr. Chairman, I thank you for your great courtesy.

Mr. STEARNS. Thank you. The full chairman, Mr. Barton.

Chairman BARTON. Thank you, Chairman Stearns. I want to again thank this panel for being here. I want to focus on stock options and FASB a little bit, but since Mr. Dingell brought up the issue of Enron, I think I need to say a few things about that.

This is the committee that did the investigation, that found the facts that led to all the indictments of Enron, the Energy and Commerce Committee Oversight and Investigations staff. Chairman Tauzin worked very hard to expose that. I totally supported it. But my recollection of Enron was that they decided, the corporate leadership, that they had a new corporate model that was not asset based, that they decided they could run a corporation based on trying to capitalize transactional expertise in their trading and, to the extent they had asset problems, they spun them off into these spe-

cial entities and tried to convince the capital markets that they had a new way of making money without having any assets to back it up. Their problems had nothing to do with stock option accounting or whether it was disclosed or expensed. It had everything to do with running a corporation with no assets.

I have simplified it, but is that generally what happened? They tried harder and harder to hide the fact they had no assets and it finally caught up with them?

Mr. WALKER. Mr. Chairman, it was primarily dealing with special purpose entities, and that was their problem. At the same point in time I think it is legitimate to ask what is the proper accounting for stock options.

If I might quickly add, one of the things that I heard Mr. Mayer and Mr. White say was their concern about whether this would have an adverse economic impact. I would raise as a related question, namely, since you have to disclose in your financial statements what the impact would be on a fair market valuation basis, anyway, a sophisticated investor would see that. Since it is a noncash item, I don't understand why having consistent accounting treatment is going to have an adverse impact, because the fact of the matter is a sophisticated investor would consider that anyway.

Mr. WHITE. But we want accounting for unsophisticated investors, too. At least that would be our argument.

Chairman BARTON. That is true. I agree with that. Let me ask some questions about stock options.

There is nothing in the law or in SEC regulation that prevents a company from expensing stock options right now, isn't that true? If I am the CEO or the board of directors and I want stock options expensed, generally accepted accounting principles don't prevent that. It can be done. We don't have to have a Federal law to expense stock options. We can make it mandatory, but you can do it voluntarily if your corporate board wants you to. Isn't that correct?

Mr. MAYER. Absolutely, under FAS 123, and the 575 companies that have done that are typically the companies that either don't have a lot of options or for whom the impact is not particularly large.

Chairman BARTON. Again correct me if I am wrong, but under current law there is nothing that says companies have to grant stock options but those that do, if they make the decision, they have to disclose in their annual reports the number of options that are granted above a certain percent, they have to disclose who they are granted to and they have to disclose the strike price at which they can be exercised, isn't that correct?

Mr. MAYER. That is correct, and the estimate of fair value of those options.

Chairman BARTON. So if I am a financial analyst and can read, I can read that and if I am the unsophisticated investor that Mr. White is referring to, I may not understand it but I can read it and I can call a financial analyst that for a nominal fee can explain it to me. Isn't that correct?

Mr. MAYER. That is correct. And it will be much harder to go the other way.

Chairman BARTON. What is the worst documented example of a stock option scandal that has defrauded unsophisticated investors

in that company? Are there examples of companies that somehow cooked the books on these stock options and the senior management exercised their options and ran off to Cancun and left these poor unsophisticated investors with nothing?

Mr. MAYER. I am not aware of any.

Chairman BARTON. Is anybody aware of a real world example of a stock options scandal?

Mr. WALKER. We haven't researched that. Let me just say, if people think that an unsophisticated investor is going to understand the footnotes of a financial statement, that is totally unrealistic.

Chairman BARTON. I am just trying to find out. We have a major bill. We have had a real debate in the last several years about expensing stock options. Chairman Greenspan of the Federal Reserve has said we ought to expense stock options and I think Warren Buffett has said we ought to expense stock options. So the prevailing winds which used to be way back when, when I was in the private sector, they didn't need to be expensed. Now the political wisdom is they need to be expensed. But if we are going to legislate, I want to know, are there real world examples where the stock options not being expensed has led to real abuse and real investors being defrauded. I am not aware of one. That is why I am asking the question.

Mr. WALKER. I am not aware of one. I would be happy to take a look at it, if we were asked to do so. I would say, however, we have to decide whether or not we want to be a leader or a laggard with regard to accounting and reporting. We are lagging the world in this area.

Chairman BARTON. So the rest of the world, these paragons of economic activity in Western Europe are expensing and they certainly have been leaders, and the Chinese who didn't even have stock markets until 10 years ago, maybe they are expensing them, including everything that the Communist politburo in Peking gets under the table that we never hear about, so now we have got to decide to expense.

Mr. WHITE. Mr. Chairman, that is a really good point. Actually the Chinese are not expensing. They have learned from us. In the 5-year plan of the Communist Party of China, they encourage the use of stock options to give workers more access and more ability to own the success of the company.

I would also say I think there is a little misunderstanding about what has actually happened in Europe. It is true that the International Accounting Standards Board has finalized their standard, but there is a lot of uncertainty as to whether the political process over there is going to allow that standard to become effective. It has been approved by the Commission but it has not been approved by the governing body of the EU, which has to approve it before it can take effect.

Chairman BARTON. I am going to come back to Mr. Herz because he is the long suffering Chairman of the Financial Accounting Standards Board, which is kind of a thankless job, and if there is a reason to expense stock options, I would stipulate that that reason is to give confidence to investors that everything that can be done is going to be done to try to have accountability at the senior management level of these corporations, that there may not be a

financial reason to do it but there may be an openness, transparent, confidence reason to do it. If you are going to go down that trail, I think Mr. Dingell's question about why stop at the top five has got relevance.

If we expense stock options, I think FASB's rules were you are going to expense them for everybody and Mr. Baker's bill was just the top five. You know, is there some magic demarcation line if you believe expensing is the way to go that we ought to do it, or do you really feel very strongly if you are going to expense it they should all be expensed?

Mr. HERZ. Well, if you believe something is expensed, then the financial statements are wrong and incomplete without all those expenses being portrayed in it. I mean, you are again saying, you know, why don't we just figure out how many of the pensions, we go down to that level. I think that would be a very slippery slope for us to go down. Financial statements are supposed to be a faithful representation of the transactions and events as they affect the company.

Chairman BARTON. So you think for total transparency and accountability, if you are going to have expensing it should be for everybody.

Mr. HERZ. I believe so.

Chairman BARTON. Mr. White, do you think that there can be an in between.

Mr. WHITE. Well, there actually can be an in-between, and I think the place where you would draw the line would be right about where it is, where you are preventing people who might have the ability to manipulate the price of the stock to feather their own nest and to make their options worth more. You are preventing that level of person from doing it. But, you know, for goodness sake, let us not prevent ourselves from giving these stock options to the administrative assistants and the engineers assistants and the people all the way down the line who have been so successful in creating innovation in these companies. That is really what we are trying to accomplish.

Chairman BARTON. My time has expired, and I have got one more question I want to ask, and Mr. Herz wants to add, I think, something to what Mr. White just said.

Mr. HERZ. First of all, we are not against stock options or saying that companies shouldn't grant stock options or that stock options are better or worse than restricted stock or performance grants or cash bonuses or having day care centers for the employees or training or whatever. We are just saying let us do the right accounting.

Chairman BARTON. Now, this is my final question, and it is an "unsophisticated investor-type" question. If I get a stock option, and let us make this as simple as possible. I get a stock option for one share of stock at a strike price of $100 2 years from the date the option is granted, and I can take that stock option or I can get a cash bonus payable next month for $100. So I can have $100 cash that I get next month or I can have a stock option worth $100 at the strike price payable in 2 years. If we decide to expense stock options, do I create, if we expense them, a tax liability on $100 that is payable this calendar year, or do I get to defer that until it actually materializes?

Mr. HERZ. My understanding is that the prevalent tax treatment for what are called nonqualified stock options, which is the major stock options that are issued by companies, the tax treatment is that the recipient will have taxable income upon exercise of that option.

Chairman BARTON. So I don't have to pay—even if we expense it, I don't create a tax liability in the current year that I have to pay. I don't have to pay the taxes until I realize something, that there is actually a financial asset that I can pay part of.

Mr. HERZ. Again to you.

Mr. MAYER. Under current tax law, the tax liability is not related to the incurrence of expense by the corporation. They are completely separate.

Chairman BARTON. So if we expense stock options, there is not a cash-flow negative to the stock option holder; there is a contingent fund requirement of the granting corporation to set up a reserve fund for that option. Is that correct?

Mr. MAYER. That is not a reserve fund, but the taxation of the individual is completely separate from the taxation of the corporation, unless Congress or the IRS chooses to change the regulations. But under current regulations what the corporation does does not affect the individual.

Mr. STEARNS. The gentleman's time has expired.

Mr. Davis is recognized for 8 minutes.

Mr. DAVIS. Thank you, Mr. Chairman.

I would like to ask Mr. Herz and then Mr. Walker if—and I don't know how to talk like an accountant, so I will try. In ascertaining whether an expense or another accounting item should be included in generally accepted accounting principles, is there such a thing as an expense or item that is so sufficiently—that is so difficult to quantify that it should not be made a part of generally accepted accounting principles? And, if so, can you offer an example?

Mr. HERZ. There are very few examples. But in every project we look at that issue, of whether there is in our view a sufficient reliability, and that is a judgment that we have to make based upon a lot of input, data, visits to companies, looking in the case of this kind of thing of valuation, to valuation experts, testing out a lot of things experienced in other places than that. And then we match that up against other items. This item, well, we are still getting more data, but certainly it has already been in the audited footnotes for 8 years. It is based upon accepted models.

The inputs do involve some judgments, as Mr. Mayer said. But in fact that realm of judgment is probably less than in many other areas of accounting that involve considerable judgments, and in fact that is recognized by most users of financial statements. There is a required disclosure by the SEC of what is called critical accounting estimates, which a company has to lay out the areas that involve most estimation and subjectivity. Those areas can be eight, nine, 10 in a particular company. Some of them can—my belief and from valuation experts, are more difficult to do than this item.

Mr. DAVIS. So there is such a thing as an item that is not sufficiently reliable, and therefore not something that you would try to assign a value to?

Mr. HERZ. There are some things like that, but they are very few in number and diminishing. I am getting use of one here that in contract accounting, construction contracts for example, one uses the—you don't use the percentage of completion method for a long contract, you use a completed contract method. If you think the estimates are not sufficiently reliable, you go to an alternative measure. But you don't assume zero either.

Mr. DAVIS. That is an interesting example you pick, because I actually—well, I have sued someone for fraud for trying to state as a fact what is not a fact, which I guess gets me to another question—I will let Mr. Walker respond to this—which is, I think you are acknowledging that there are genuine issues as to the reliability of this value but you think the reliability meets the sufficiency threshold. But are we going to create a level of uncertainty in terms of how a corporation prepares its financials and uses people to prepare financials, such that we are going to have a lot of liability?

Mr. WALKER. I don't think that we are going to create a significant degree of uncertainty. The fact of the matter is there are two issues. One issue is whether or not you should account for these in a consistent manner based upon a fair market value basis. And then, second, how you do it.

With regard to the first, I believe the answer to that question is, yes, you should have consistency in order to improve integrity and public confidence and avoid adverse selection.

With regard to how do you do it, reasonable people can differ. Namely, Black-Scholes versus the proposed method. I think that is a legitimate discussion and debate, if you will. But I do think this is one that there are generally accepted methods out there; e.g., Black-Scholes, that have been used for a number of years and have already been reported and, therefore, there is a basis to accomplish the objective.

Mr. DAVIS. Are you or—Mr. Herz.

Mr. HERZ. I should add, first, we are continuing to do some work on that. Some of the large high-tech companies have said they have done some work, and we are going to be meeting with them and we would like to look at what they have done. But also the SEC staff has said that, you know, to the extent if there are genuine fears here and there is some legitimacy of those after we go through all that, they are prepared kind of below our principles to perhaps put in some safe harbors for companies on some of these assumptions. But that all has to still—we are not finished, so we are going to look at all those things.

Mr. DAVIS. Have you done studies that give you the benefit of hindsight to go back and use either of these methodologies to judge what would have caused one of these types of companies to quantify as an expense for an option versus what the actual experience was in terms of volatility and choice as to exercise? And what did that tell you about the sufficiency of the reliability of your methodology?

Mr. HERZ. Well, that is a good question and it gets to kind of a fundamental point, that when you value something you value it at that point in time, and that is a valuation for an option that takes into account thousands if not millions of potential scenarios. That

is the way it works. It is not trying to pinpoint at one particular scenario. Just like the stock price at one point in time is a valuation at that point in time, it is not going to predict what the stock price is going to be 2 years from now, 3 years from now, 4 years from now. So it is the valuation at that point in time, it is not a prediction.

Mr. DAVIS. Okay. Do you or Mr. Walker—you haven't really answered my question. Have you even attempted to go back and do that type of study in hindsight? And would it be useful to do so? I understand your point as well.

Mr. WALKER. We haven't at GAO. I have got to believe that there are studies that have been done along those lines in the private sector.

Mr. DAVIS. If you all don't know, that is troubling.

Mr. HERZ. Well, there have been studies that show the actual outcome. Just like I said, it is like you enter a lottery and you pay $4 for a lottery ticket, and you may win the lottery or you may not win the lottery. The ticket was still worth $4. Now, some people are going to win the lottery and others are not. But those are what these models do, is they, based on all the outcomes, come up with a value at the date you are doing——

Mr. DAVIS. Well, but when I buy a lottery ticket it tells me what the prize might be. It doesn't tell me what my chances are of winning necessarily.

Mr. HERZ. It certainly does.

Mr. DAVIS. Well, people don't—I don't know that people really rely upon that.

Mr. HERZ. The chances of winning this lottery are much higher on average than an average lottery.

Mr. DAVIS. How—to the chairman's question, what is the level of urgency here? If you come to the conclusion that the type of studying I describe is a useful exercise, do you think that you have the luxury of spending more time doing this or do you feel compelled to come to a result very shortly?

Mr. HERZ. We have to balance everything. What we want to do is get to a good answer, a quality standard, and we are going to consider all the input we have got and continue the input to get to a good standard. I will tell you, though, that investors, analysts believe that this should have been done a long time ago and they are anxious. And serving the capital markets, we have to also consider that issue, also the issues of, you know, the implementation, time lines. All those are the kind of issues we work on when we decide what kind of timeframe we ought to do.

Mr. DAVIS. Mr. Chairman, if I could ask one more quick question of Mr. White and Mr. Mayer.

The bill, as I read it, contemplates the possibility that some form of methodology that is sufficiently reliable might be developed, But I think what I have heard you all testify to today is you don't believe that is going to occur, and perhaps a more credible description of the bill is to basically—that it basically stands for the position that this is, we are trying to know the unknowable here.

Mr. HERZ. I think that is true, and I think that actually, you know——

Mr. DAVIS. And I am not saying that I agree with that. I just want to understand your position.

Mr. WHITE. The reason it is unknowable is—and I think Chairman Herz has defined it very well. What they are shooting for is the abstract idea of what these things are worth on the grant date. They don't really care about what turns out to be the case in the future. And if you look at an example like Cisco, if you run those numbers, you get some absolutely dramatic results. $3 billion.

Mr. DAVIS. Thank you.

Mr. STEARNS. The gentleman's time has expired.

We have three members left and we have six votes. So I would just ask the members, or a suggestion, if anyone wants to submit their questions rather than coming back, we could go for possibly another 10 minutes. We could probably get 5 minutes on each on a side and then we could adjourn, so you folks wouldn't have to come back after six votes, which, Rick, as you know, this could be a long time.

So at this point Mr. Bass would be the next. And Mr. Bass, my suggestion is——

Mr. BASS. Mr. Chairman, I will tell you what I will do. I am going to take 3 minutes instead of 5, and then I am going to yield 2 minutes to whoever is after me. All right?

My position on this bill has not been predetermined before this hearing, and I am not an accountant either. But I have run a small business before, and I learned through the school of hard knocks that there is only one fact in accounting, and that is cash. And even accounts receivable, inventory, value of fixed assets, backlog, anything, those are all opinions.

However, I think cash, bonuses, the cost of day care, and other things that Mr. Herz brought forth really are a fact because they are cash expenses.

I believe that it is perfectly legitimate for Mr. White to present a different opinion or a different perspective on the issue of accounting than the two gentlemen from the General Accounting Office and the FASB. It is a legitimate part of this debate. And I appreciate your testimony, Mr. White. I don't find it patronizing at all. I also don't understand why Enron is the subject of every single debate that we have had this week. And I agree with my friend, Mr. Barton, from Texas that the issues with Enron were quite—the issue of expensing of options is really superfluous to this debate.

My question for—a quick question is, a concern that I have that was evidenced to me by Mr. Greenspan when we had a meeting sometime ago, that the accounting standards or the accounting practices of businesses is becoming increasingly divergent from what they submit to the Internal Revenue Service for tax purposes.

Do you have any comments on that and how this issue addresses that?

That is my only question, and we will cut it off in a minute.

Mr. WALKER. Well, it is interesting to note that corporations do get deductions on their income tax return with regard to the value of stock options even in circumstances where they don't have to record an expense in their financial statements. And it could be significant——

Mr. MAYER. Well, that is a bit of an overstatement. Not all stock options result in a tax deduction. In fact, only a limited variety of stock options do, and then only when there is a concomitant tax liability or obligation on the part of the individual who has the stock option. So there is a perfectly matched situation there, and the notion that corporations are getting a big tax deduction without reporting the expense is completely off the mark, in my view.

I would add, if I may, quickly, that I deal with investors and analysts every day and I have for 20 years as a CFO of a publicly held corporation. Not one, not one single one has ever said to me, you know, you can expense under FAS 123. Why don't you do that? We would like it if you would do that. Not a single one has ever asked me to do that. I dispute the fact that this is a human cry from that community.

Mr. BASS. I yield to the gentleman from California.

Mr. ISSA. Thank you, and I will be very, very brief. I guess my first reaction was hearing that there were 14 accounting firms, including the ones that did WorldCom and Enron. I, like my colleague, can't understand why we are going to base it on accounting firms as the basis for it. Plus, to be honest, Mr. Chairman, if I were an accounting firm, I would not say anything adverse to the Chairman of FASB.

Mr. HERZ. They do all the time.

Mr. ISSA. But I will say, and I, like my colleague, have not made a decision on the underlying bill, including some of the possible amendments. But I was concerned, Mr. Herz, when you said that you were concerned about disadvantaging some companies, as though your job was to level the playing field between companies. And you can respond in writing because I don't want to take more time than this 2 minutes.

Mr. STEARNS. The time of Mr. Bass has expired. So if you will answer the question, and then we will ask Mr. Stupak.

Mr. ISSA. I will take it in writing because I know we are in a hurry. Thank you.

Mr. STEARNS. Thank you.

Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman.

You know, I sat through the Enron hearings. And this double stock options was a problem. And let me explain the way it was, because I think it really summarizes where we have been.

The last 5 years before declaring bankruptcy, from 1996 to 2000, Enron told its stockholders and the whole world that it was rolling in cash, claiming a 5-year U.S. profit of $1.8 billion. During those same years Enron deducted $1.7 billion from stock option compensation from its tax returns as a business expense, cutting its taxes by $600 million and eliminating its tax liability entirely for 4 out of 5 years. In other words, the stock option double standard allowed Enron to dole out this form of compensation to its executives, including $123 million to Mr. Lay, claim a huge tax deduction, and escape paying U.S. taxes while not showing any stock option expense on its inflated financial statements.

So this is exactly why this legislation can hurt us, and Enron had a lot to do with it and those of us who sat through it understand it.

So how come—and this is this discussion today. How come you can estimate the value of a stock option for tax purposes but you can't do so for accounting purposes? Mr. Walker or Mr. Herz, if you want to hit that.

Mr. HERZ. Well, for tax purposes it is computed at a different point in time than we are proposing for accounting purposes. We are proposing a grant date measure, which we think is the right economic measure. The Tax Code says look at the spread between the exercise price and the strike price at the time it is exercised.

Mr. STUPAK. So really you have a double standard here, once you are using and then you deduct it. And then how do you justify the double standard then?

Mr. WALKER. Well, the accounting treatment is generally recorded as of the date of grant and it is based on an estimate. Tax treatment is generally based on actual experience at the time the grant is exercised. As a result, you can have a situation where you don't ever record a financial statement expense and yet you may still get a substantial tax deduction.

Mr. STUPAK. So this has got to be zero, or you don't know how to do it because it is too complex. They already do it, because even Enron in these financial statements that many people looked at but didn't pick up because it was in a footnote, they had to put a value on the options in the footnotes. So when you say it is a zero or it is too complex, you can't figure out, that just doesn't hold water.

Mr. HERZ. Unless companies calculate it or communicate it to the executives and to the employees at the time they do it.

Mr. STUPAK. Sure.

Mr. MAYER. If I may, I have to disagree with that. I think it is dead wrong. The calculation for tax purposes is a subtraction. $10 minus $6 leaves $4 profit.

Mr. STUPAK. But even if there is a subtraction, there is still a value.

Mr. MAYER. Correct, And that is a very doable calculation that you can do. The calculation we are talking about here in the lattice model is a theoretical calculation of a number that never occurs, that can never be measured or audited.

Mr. STUPAK. Let me go to Mr. White, because he argued that there is no accurate way to estimate the value of stock options, as you said in your testimony. But the Chicago Board of Options Exchange facilitates over 8.8 million option trades each day. Do you believe that professional traders engaging in millions of trades involving millions of dollars each day do so without knowing the value of the options or buying or selling?

Mr. WHITE. No, but those are totally different. They are tradable options. These stock options aren't tradable. You can't transfer them. It is illegal to transfer them to anybody, and they have no value at the time they are granted. So it is a totally different situation.

Mr. STEARNS. We have about 4½ minutes left to get to the floor.

Mr. STUPAK. I have got some more questions. I will put them in writing.

Mr. STEARNS. Let me just conclude the hearing. And I thank the colleagues. We will leave the record open for 5 days to allow additional questions. And also, just to notify my colleagues, Chairman

Barton and Mr. Dingell and myself and Ms. Schakowsky are going to write to the Securities Exchange Commission in reference to Mr. Barton's question, which I think is very relevant: Have stock options caused any abuses because of misinformation for investors? I think that is welcomed to know.

And I want to thank the witnesses for their patience and for a lively hearing. The subcommittee is adjourned.

[Whereupon, at 3:57 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

PREPARED STATEMENT OF RICHARD L. TRUMKA, SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

> "There are cases where you can use equity to impact your income statement. And the most—the most egregious, or the one that's used by every corporation in the world is executive stock options. And as a matter of fact, I think FASB tried to change that, and you introduced legislation in 1994 to keep that exemption. And essentially what you do is you issue stock options to reduce compensation expense and therefore increase your profitability."

*Former Enron President And CEO Jeffrey Skilling before the Senate Commerce, Science And Transportation Committee on February 26, 2002*

On behalf of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and our affiliated unions' 13 millions members, I appreciate the opportunity to comment on the proposal by the Financial Accounting Standards Board (FASB) to require the mandatory expensing of stock options and on H.R. 3574, the Stock Option Accounting Reform Act.

Stock option expensing will have an unambiguously positive impact on the economic security of America's working families. Our interest in stock option expensing stems from the fact that our members are also investors. Union members participate in benefit plans with over $5 trillion in assets. Pension plans sponsored by unions affiliated with the AFL-CIO hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors.

The AFL-CIO strongly supports FASB in its recent decision to close the accounting loophole that has that has allowed corporations to understate the true cost of executive compensation. FASB's proposal is part of a global trend towards greater accounting transparency. Starting in 2005, the International Accounting Standards Board has ruled that 7,000 companies in 90 countries must start expensing stock options.

We oppose calls to postpone implementation of mandatory expensing until 2006 because any delay will only give companies time and an incentive to award megagrants to CEO's while they can still do so without recording them as an expense. Companies that are truly unable to implement expensing beginning in 2005 should have the option of delaying implementation of the rule for one or two quarters and then retroactively applying the new standard.

The FASB proposal provides a reliable cost estimate that takes into account the unique characteristics of employee stock options. It also provides broad flexibility for small businesses that are not publicly traded. Further, the FASB proposal should have zero compliance costs for publicly traded companies, as the current accounting rules already require corporations to provide investors with an estimate of their stock option expense in the footnotes of company earnings statements.

This is not the first time FASB has attempted to require appropriate expensing of stock options. In the mid-1990's, just as stock options were becoming a popular form of executive compensation, FASB attempted to require option expensing, but was pressured by Congress into abandoning its position. We believe that this thwarting of FASB's role as an independent body was a key initiator of the chain of events that led to the corporate scandals of the last several years.

This time, we hope that Congress will respect FASB's independence and not interfere with its decision. Unfortunately, though, we are seeing yet again an assault on FASB's independence. Some of those opponents of mandatory expensing are falsely attempting to portray FASB's efforts as an attack on workers. They have suggested that expensing stock options will benefit trial lawyers, encourage offshoring, and stifle innovation.

We should say at the outset that the AFL-CIO does not oppose broad-based stock options programs. We are always in favor of better wages and benefits for workers—

be they in the form of stock options, pensions or health insurance. We view stock options as one appropriate form of medium-term compensation for employees, but as an inappropriate substitute for the basic wages and benefits needed to support a family.

What we oppose is giving one particular form of compensation—in this case, stock options—preferential accounting treatment over other more important employee benefits such as wages, pensions or health care. If the corporate opponents of stock option expensing truly want to help America's working families, they should instead focus their efforts on encouraging the expansion of retirement plans and health care coverage.

*Executive Compensation and Stock Option Expensing*

Not expensing stock options has widened the pay gap between CEOs and workers. Executives disproportionately benefit from stock options and this cost has been kept off the books. Moreover, not expensing stock options has artificially boosted profit reports, thereby generating further increases in CEO pay. Unfortunately, the voice of America's working families and their retirement savings is diffused in comparison to the concentrated interest of highly paid Silicon Valley executives who are opposing stock option expensing.

In our view, stock options have only widened the pay gap between executives and ordinary workers. In 1980, prior to the widespread use of stock options in executive compensation, CEO pay stood at approximately 42 times the average worker. Two decades later, CEO pay reached 531 times the average worker's pay. The majority of this increase was due to stock options, which have become the biggest component of today's CEO pay packages.

In a last ditch effort to de-link the issue of stock option expensing from the politically explosive issue of executive pay, the opponents of stock option expensing have backed H.R. 3574, the Stock Option Accounting Reform Act. This bill purports to require the expensing of stock options for the top five most highly paid executives. However, this so-called compromise bill is a sham. In addition to creating an accounting fiction that some stock options are a cost while others are not, this bill will dramatically understate the true cost of CEO stock options.

Moreover, H.R. 3574 would prohibit companies who already expense all of their stock option grants from continuing to do so. By limiting expensing to the top five executives' options grants, this bill will force companies that already expense all of their employees' options to report less accurate earnings. According to Bear, Stearns & Co., 576 companies have announced their intention to voluntarily expense stock options, including companies representing over 40 percent of the market capitalization of the S&P 500 Index. H.R. 3574 will not just override FASB, but it will override the stock markets that increasingly demand expensing as a matter of financial transparency.

The bill would require companies using an option pricing model like Black-Scholes to assume that the underlying stock price has zero volatility. This would be accounting fraud by act of Congress. This "minimum value" approach—as its name implies—results in unrealistically low cost estimates. Moreover, the minimum value approach can easily be manipulated to drive the reported value to zero or near zero.[1] This is done by raising the exercise price and multiplying the number of options in order to maintain the real value of the grant while lowering its reported "minimum value."

The bill would allow CEOs to continue to receive stock option mega-grants without having to report the real cost to shareholders. It is no secret why Silicon Valley executives are leading the fight against option expensing. According to SEC filings, the CEOs of the ten public companies who are the corporate members of the so-called International Employee Stock Options Coalition hold on paper a combined $916 million in unexercised stock options.[2] Not one dollar of these CEO's stock options has ever been expensed in these companies' earnings statements.

Not expensing stock options has cost shareholders real money by encouraging their overuse for executive compensation. According to the Investor Responsibility Research Center, companies in the Information Technology sector have an average potential dilution from stock options of 25.7 percent, as compared to 17 percent for the S&P 1500.[3] This measure of stock option overhang is one way that shareholders

[1] Mark Rubinstein, "On the Accounting Valuation of Employee Stock Options," *Journal of Derivatives,* Fall 1995.

[2] Fiscal year 2003 data from company proxy statements.

[3] *Stock Plan Dilution 2004: Overhang from Stock Plans at S&P Super 1,500 Companies,* Investor Responsibility Research Center.

gauge the potential dilution to their holdings from the equity being transferred to executives and other employees.

*Who Gets Stock Options?*

In contrast to CEOs, relatively few ordinary workers receive stock options. At the height of the stock market boom in 1999, only 1.7 percent of private sector employees received stock options, according to the Bureau of Labor Statistics (BLS). Stock options are much more prevalent among the ranks of managers and skilled professionals; the BLS found that only 0.7 percent of private sector workers earning less than $35,000 received stock options, compared to 12.9 percent of workers earning $75,000 and above.[4]

Compared with large corporations, few small businesses grant *any* of their employees stock options. BLS data shows that only 2.1 percent of companies with 100 employees or less granted stock options, compared to 10.1 percent of companies with over 100 employees. We believe this data shows that stock option expensing will have little, if any, impact on America's small business.

Those who wish to portray stock options as a broad-based benefit typically focus on technology companies where stock options are sometimes granted to a cross-section of employees. For example, the American Electronics Association claims that publicly-traded technology companies grant stock options to 84 percent of their employees.[5] Even in Silicon Valley, however, households with stock options are in the upper tax brackets, with a median income of $122,000.[6] According to SEC filings, the CEOs of the ten public companies who are the corporate members of the so-called International Employee Stock Option Coalition (the "IESOC") hold on paper a combined $916 million in unexercised stock options. The authors of the book *In the Company of Owners* estimate that "roughly 30 percent of all options are in the hands of top five executives" and "most of the remaining 70 percent is spread very narrowly among other executives and managers."

For the reasons discussed above, these statistics are unlikely to change. Stock options are ill-suited either as a way to make ends meet from day-to-day or as a substitute for a traditional defined benefit plan or a properly diversified defined contribution plan. As a result they have been and are likely to continue to be supplemental medium-term compensation for high-income employees.

*Investor Concern*

We agree with FASB Chairman Robert Herz, who last year testified before the Senate that "financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermine the credibility and value of that information and the proper functioning of the capital markets by impairing investors' capital allocation decisions."[7]

We believe we speak for most investors on this issue. In a report released earlier this year, the Congressional Budget Office concluded that "recognizing the fair value of employees stock options is unlikely to have a significant effect on the economy (because the information has already been disclosed); however, it could make fair value information more transparent to less-sophisticated investors."[8]

Since 2003, a majority of shareholders at 44 companies have voted in favor of resolutions to require stock option expensing. These include high-profile technology companies such as Intel, Apple Computer, Adobe Systems, IBM, and Texas Instruments, despite strong opposition to expensing by these companies' boards of directors. Other high-tech companies such as Microsoft, Amazon, and Netflix have joined the nearly 600 companies that voluntarily expense stock options.

There is also near unanimity in favor of mandatory expensing among institutional investors and governance advocates, including the "Big Four" accounting firms, the Conference Board Commission on Public Trust and Private Enterprise, the Council of Institutional Investors, Institutional Shareholder Services, and the Teachers Insurance and Annuity Association—College Retirement Equities Fund.

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[4] Bureau of Labor Statistics, "Pilot Survey on the Incidence of Stock Options in Private Industry in 1999," press release October 11, 2000.

[5] "AEA Study Finds 84% of High-Tech Workers Receive Stock Options," AEA press release, August 14, 2002. (This survey almost certainly suffers from selection bias, as AEA members with broad-based plans had more incentive to respond.)

[6] 2002 Gallup Poll of Media Use and Consumer Behavior for the San Francisco market, cited in Mark Schwanhausser and Jeanne Cardenas, "Stock Options Slow After Dot-Com Bust," *San Jose Mercury News,* December 13, 2002.

[7] Statement of Robert H. Herz, Chairman, Financial Accounting Standards Board, for the Roundtable on "Preserving Partnership Capitalism Through Stock Options for America's Workforce," United States Senate, May 8, 2003.

[8] "Accounting for Employee Stock Options," Congressional Budget Office, April 2004.

Individuals such as Berkshire Hathaway CEO Warren Buffett, Securities and Exchange Commission Chairman William Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, General Accounting Office Comptroller General David Walker, Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul Volcker, and Nobel Prize-winning economists Robert Merton and Joseph Stiglitz are all in favor of mandatory expensing.

*Valuation Issues*

Opponents of mandatory expensing have exaggerated valuation issues related to stock options. They claim, for example, that options cannot be accurately valued, that options vary in value after they are granted, and that options turn up in earnings per share calculations.

The fair value of stock options can be estimated using the Black-Scholes-Merton formula or a binomial lattice model that incorporates employees' expected behavior. Though these values are estimates, so are the values used for numerous other line items on corporate financial statements, including depreciation, amortization, and inventory-related adjustments. Options do vary in value after they are granted—but so do a variety of payments and agreements made by companies including payments made in foreign currencies or long-term commodity contracts. No one would suggest that these should be left off the companies' financial statements.

Opponents of expensing contend that options are double counted if they are charged to earnings, because the cost of options is already reflected in dilution. This argument ignores the opportunity cost of granting stock options to employees. Moreover, other forms of equity compensation that are expensed also result in dilution. For example, the estimated value of restricted stock grants to employees is deducted as a compensation cost, affecting both the EPS numerator and the denominator. To ignore the cost of stock options in the numerator is to assume that revenue-increasing labor services provided in exchange for stock options are provided free of charge.

As for the claim that pricing methods overstate the value of employee stock options because employees may exercise options early and may forfeit options if they leave the company, FASB has already addressed this issue. FASB would allow companies to modify cost estimates to reflect patterns of forfeiture and early exercise, and adjust these estimates, if necessary, based on subsequent information.

*Perverse Incentives*

Because stock options have received preferential accounting treatment, companies have been reluctant to innovate when it comes to executive compensation. Many companies, for example, have told us that they are reluctant to use performance-based stock options that are indexed to their competitors because indexed stock options must be expensed under the current accounting rules. That's bad news for Americans' retirement savings, which depend on companies having responsible CEO pay.

Unlike actual share ownership, stock option grants to CEOs create perverse incentives that are not in the best interests of long-term shareholders:

- stock options can encourage executives to take excessive risk-taking by promising all the benefit of share price increases with none of the risk of share price declines,
- stock options can reward short-term decision-making because many executive stock options can be exercised just one year after the grant date;
- executives can profit from share price volatility (a measure of shareholder risk) by timing when they exercise their stock options;
- because option holders are not entitled to dividends, dividend yields have fallen to historic lows, and many companies have instead used this cash for stock buybacks to prevent dilution from executives' stock option exercises; and
- stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

The Securities and Exchange Commission has been examining whether some companies—particularly in the high tech sector—have inappropriately timed their stock option grants to executives.[9] By granting stock options just prior to releasing market-moving information that boosts the stock price, companies can simultaneously put extra money into the pockets of executives and understate the estimated costs of these option grants in their SEC filings. Given all these drawbacks, we believe an over-reliance on stock options for executive compensation has contributed to many of the corporate scandals we have witnessed in recent years.

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[9] Deborah Soloman, "SEC Probes Options Grants Made As Company News Boosts Stock," *Wall Street Journal,* March 30, 2004.

*Conclusion*

The goal of accounting is to facilitate accurate comparisons between companies—a goal not being met under the current system, when some companies expense options and others do not. If stock options are not expensed, a company that pays its employees in stock options has lower compensation costs and therefore artificially higher earnings. As former Enron CEO Jeffrey Skilling explained in his Congressional testimony, "you issue stock options to reduce compensation expense and, therefore, increase your profitability."

Companies that do not expense stock options are hiding their true cost from investors, creditors, and other consumers of financial reports. FASB's decision to require stock option expensing in 2005 will strengthen investor confidence in financial statements. The efficient allocation of capital to the most economically valuable business activities depends on consistent accounting rules. For this reason, we believe all businesses should expense stock options, so that stock options do not artificially boost any company's profit reports. Congress should let FASB do its job.

We appreciate the opportunity to present our views on this important matter.

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June 29, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Re: Exposure Draft: Proposed Statement of Financial Accounting Standards
Share-based Payment
File Reference No. 1102-100

To Whom It May Concern:

I am writing in response to your request for comments on the Exposure Draft of the Proposed Statement of Financial Accounting Standards related to Share-based Payment. I am a member of the Small Business Advisory Committee to the FASB and recently participated in the first Advisory Committee meeting held at your offices on May 11, 2004.

I could not be more opposed to the implementation of this new standard for a broad range of reasons. First and foremost, I believe it is bad accounting. Financial statements will become less transparent, less comparable, more volatile, less understandable and less useful to the vast majority of readers. Second, I believe that implementation of the standard will be extremely costly, time consuming and difficult to audit. As one who signs numerous certifications that our financial statements are correct, accurate, in full compliance with accounting standards and SEC regulations and fairly present the financial condition of our company, I am very concerned about a standard such as this which will result in very material changes to our financial statements based solely on our guesses and estimates of future events which may be years off. Finally, I believe that implementation of this standard is bad policy, and will have a detrimental effect on our economy and on a broad range of rank and file employees who today have an opportunity to accumulate wealth through participation in the value they create, and through alignment with the interests of investors.

My specific comments follow:

First, the title of the Exposure Draft is misleading and incorrect. The granting of a stock option is not a share-based payment, it is not a payment at all. An SAR is a share-based payment, since it results in a cash payment based on the price performance of the underlying shares. Similarly, a phantom stock plan may result in a cash payment based on the performance of the underlying shares. A stock option is not a payment at all; rather, it is a right to participate in the creation of value of an enterprise. If no value is created, no payment is made by the enterprise and no value is gained by the option holder. If value is created, again, no payment is made by the enterprise but value is gained by the option holder in direct proportion to the value gained by the stockholders.

**Recognition of Compensation Cost**

***Issue 1:*** *The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.*

No. Stock option compensation cost should not be recognized in the income statement. The result will be a reduction in the transparency and comparability of financial statements due to the difficulty and variability of estimating stock option expense. Expense will vary widely from company to company and will, in effect, introduce stock price volatility into the income statement. For many companies, particularly those with broad-based plans, stock option expense will overwhelm actual operating expenses, making prediction of operating results and cash flows difficult if not impossible. P/E ratios will become even more volatile as reported earnings bear less relationship to operating cash flows and to enterprise value. Expensing stock options will introduce into the income statement an item that will never, under any circumstances, become a cash outflow.

The conceptual framework in CON 1 provides that "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." It further states that "...financial reporting should provide information to help investors, creditors and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise." The argument that stock option expensing will somehow increase the transparency and comparability of earnings is completely backward. Because of the complexity and difficulty of estimating option expense, comparability among financial statements will be diminished, and only those with sophisticated financial analysis capabilities will be able to restate the financial statements to put them on a comparable basis (i.e. without stock option expense). Even those who possess this level of sophistication will not have sufficient information to make all of the necessary adjustments, since compensation expense will be buried in virtually every operating expense line item and in many of the balance sheet accounts as well (i.e. inventory).

The conceptual framework in CON 5 provides that "revenues and gains are realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash." The general requirement of certainty in amount and time are not met by this proposed standard.

The conceptual framework further provides in CON 6 that "Expenses represent actual or expected cash outflows that have occurred or will eventuate as a result of the entity's ongoing major or central operations." By this definition, the grant of a stock option can never result in an expense since the option will never result in a cash ***outflow*** from the

entity. In fact the option, if exercised, will result in a cash ***inflow*** to the entity as a capital stock transaction. The economic reality of the issuance of an option is a dilution of the interests of stockholders as the result of sharing a portion of the ownership of the company with employees. This economic effect is already recognized in dilution of EPS and has no bearing on the earnings of the entity, or on its ability to generate cash flows.

***Issue 2:*** *Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?*

No. Current disclosure requirements provide a great deal of information regarding the number, kind and distribution of option grants among employees. Because of the great variability of estimates of option expenses based on different assumptions about stock price volatilities, employee behavior patterns, vesting requirements, interest rates, etc., the option expense calculation will not be in any way comparable from company to company. Thus, embedding such a number into the financial statements will only reduce comparability. With disclosure, the information is there for any reader to use as he or she sees fit. With recognition, the expense estimate will be embedded in the statements where readers will not have the ability to back it out.

If current disclosure is deemed inadequate, let's improve the disclosure, not ruin the income statement. Of the many people and organizations I know who are adamantly opposed to stock option expensing, not a single one objects to improved disclosure. This is because they all believe that providing investors with ***useful*** information is good for our companies and our capital markets.

**Measurement Attribute and Measurement Date**

***Issue 3:*** *This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?*

No. Although it may be appealing on a theoretical basis to require recognition on the grant date at fair value, the practical realities are daunting. This method will require a huge amount of estimation and calculation on a quarterly basis and will be extremely difficult, if not impossible, to audit. Good accounting practice requires that amounts be reasonably certain in amount and timing before they are recorded in a company's books. Option expense is neither reasonably certain in timing or amount.

A far more practical approach would be to recognize expense at fair value on the date of exercise. This would eliminate all estimation and guesswork regarding the probability and value of exercise and yield a clear, one time, auditable expense calculation that would not require an army of consultants to verify.

**Fair Value Measurement**

***Issue 4(a):*** *This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability*

*absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?*

No. The statement provides almost no guidance that will ensure consistency of application. In fact, consistency of application is virtually impossible because the nature of the fair value calculation is only a theoretical estimate of what a market participant might pay for such an instrument. Unlike virtually every other accounting measure, which is based on actual, measurable cash events, the fair value estimate of a stock option is a theoretical measure of an event which never happens.

Although you have been advised by "valuation experts" that tools exist to make these theoretical estimates, these tools are extremely complex, unproven, and not commonly used in practice. The large number and broad range of assumptions required to arrive at a valuation using these models will result in vast differences of application and valuation, and will by definition not be comparable. The accounting firms will require extensive backup for each assumption in order to render an audit opinion. While the "valuation experts" will, of course, advise you that this can be done, it can only be done with extensive support from the "valuation consultants" – a conflict if ever I've seen one.

The rank and file accounting staffs of the vast majority of public reporting companies are not equipped to implement this requirement without substantial expense and support, and FASB has provided little or no guidance on how to implement the requirements. The Exposure Draft should explicitly permit the use of the Black-Scholes model and should provide examples of adjustments that could be made (and are currently being made for footnote disclosure) to recognize the shortcomings of the model. Small companies, in particular, will have a very difficult time implementing and auditing a lattice model approach. Paragraphs B13-B30 serve only to add more questions relating to the many parameters which must be considered for each of the major assumptions to the lattice model. This only broadens the range of issues to be addressed. Proper guidance would narrow the range by providing answers to these questions.

***Issue 4(b):*** *Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with*

*sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?*

No. While a lattice model may be an improvement over the Black-Scholes model from the standpoint of greater flexibility, it is subject to the same and even greater problems with respect to the number, complexity and uncertainty of assumptions required. Most small technology based companies have very limited accounting staffs, and limited cash resources to apply to theoretical exercises such as this. For small companies the cost of implementation far exceeds any benefit that would result from the calculation of a theoretical non-cash cost estimate. Auditors will require the use of a preferred method unless it can be demonstrated that use of the method is not possible. This places a tremendous burden on companies trying to implement a new and complex standard.

The FASB should explicitly allow the use of the Black-Scholes model and provide guidance on adjustments that could be made to recognize the shortcomings of the model in its application to employee options. This approach would at least be able to be implemented by most filing companies, and would provide an audit safe harbor.

***Issue 4(c):*** *Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.*

Estimating volatility is one of the most difficult problems in implementing any fair value model of stock option expense. It is also the single factor with the largest impact on the resulting expense estimate and is the most difficult number to audit. Different companies will use different methods and assumptions to estimate volatility and thus the results will not be comparable. Companies will have an incentive to select a method that minimizes volatility, and hence option expense. This is an excellent example of an area where the FASB has not provided nearly enough guidance. Paragraphs B24-B26 only raise additional questions. One of the largest components of volatility in the technology and biotech sectors is market volatility. This is a component over which companies have neither control nor any predictive ability.

If, however the FASB mandates a particular method to estimate volatility, it will clearly not fit many of the companies forced to use it (e.g. the use of historical volatility mandated under FAS 123). This problem is inescapable, and is one of the strongest reasons that option expensing is a bad idea that will result in less comparability and less utility of earnings reports.

***Issue 4(d):*** *This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate*

*recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.*

Asking companies to estimate the exercise behavior and post-vesting employment termination behavior of potentially hundreds or thousands of employees is not accounting, it is stargazing. When possibly the largest single expense category on a company's financial statements is determined by such guesswork, the resulting financial statements will cease to be transparent, comparable or useful.

***Issue 5:*** *In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?*

No. This method effectively makes the stock market value of the company an element in its income statement. It may for some technology companies be one of the largest components of the P&L, moving up or down quarter to quarter with the whims of the market. A better alternative would be APB 25.

**Employee Stock Purchase Plans**

***Issue 6:*** *For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?*

Yes, I agree with the principle. However, if companies are forced to expense the difference between the employee purchase price and the fair value on the date of purchase, I think these plans will cease to exist.

**Attribution of Compensation Cost**

***Issue 7:*** *This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?*

Again, on a theoretical basis recognition over the service period seems appropriate, but in practice it is not feasible. First, what is the relevant service period? Is it the year of grant? the vesting period? the holding period? Is it different for each employee, depending on how the employee views the grant? Second, recognition of what? Even though a theoretical fair value estimate can be calculated, there is no way of predicting at the grant date that any value will actually be realized.

***Issue 8:*** *Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?*

No, the guidance is not sufficient. See answers to Issue 7 and Issues 4a-4d above.

***Issue 9:*** *For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?*

No. This will create a nightmare of complexity for anyone involved in administering broad-based plans. We currently have over 7,000 individual option grants, each with monthly vesting over four years. If each vesting tranche must be valued separately, I will have over 330,000 valuations to make each quarter, each with multiple assumptions about future employee behavior, interest rates, and stock market volatility! This will bring my accounting department to its knees.

**Modifications and Settlements**

***Issue 10:*** *This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.*

Again, these principles are perhaps theoretically appropriate, but entirely too complex to implement successfully and consistently. The approach taken in APB 25 would be preferable.

**Income Taxes**

***Issue 11:*** *This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?*

Your discussion in paragraphs C128-C138 demonstrates, again, the problem of trying to force-fit an expense notion onto what is fundamentally a capital transaction. The ED would require maintaining a deferred tax analysis at the individual employee level. While this may be feasible for corporations where only a few top executives receive stock options, it will be a crushing burden for companies with broad-based plans who will be required to maintain tens or even hundreds of thousands of calculations. If you revert to APB 25, the tax accounting becomes clear.

**Disclosures**

***Issue 12:*** *Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.*

Any disclosures that provide meaningful information to investors are welcome. In fact, those of us who oppose stock option expensing would welcome additional disclosures as the preferred alternative. Unfortunately, a significant portion of the proposed additional disclosures in paragraphs B191-B193 deal with documenting the extensive and subjective assumptions required to develop a stock option expense estimate using the lattice model. Other than providing fodder for plaintiff's lawyers, I don't see how these guesses about future employee behavior or future stock market volatility are at all useful to an investor interested in performance of the enterprise.

I suggest that additional disclosure requirements be developed to enhance the understanding of the dilution impact of stock options and that all disclosures related to the determination of a theoretical value of stock options be limited to those currently provided.

**Transition**

***Issue 13:*** *This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?*

No comment on transition.

**Nonpublic Entities**

***Issue 14(a):*** *This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?*

No. If you want comparability, consistency and transparency why create different treatments for different classes of companies.

***Issue 14(b):*** *Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those*

*entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?*

If comparability and transparency is the goal, permitting different classes of companies to use different methods and different transition rules does not support the goal.

The Board has not come close to recognizing the costs of transition and compliance that will be incurred by all companies across the board. In my opinion, these costs far outweigh any benefit that might be realized by this new standard (and I actually believe there will be a detriment to users of financial statements). In addition to the substantial amount of time that will be required of accounting staffs at each company, most companies will have to retain valuation consultants to assist with the development and implementation of these new, complex models. Few accounting professionals today are familiar with lattice models and fewer still are competent to estimate employee behavior and stock price volatility over long periods into the future.

The Board has also failed to recognize the difficulty and cost of auditing these new estimates. Particularly for smaller companies with broad based option plans, where the option expense estimate will be a very material component of earnings, auditors will be very reluctant to sign off on these material estimates without extensive documentation and analysis.

**Small Business Issuers**

***Issue 15:*** *Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?*

No. If you want comparability, consistency, and transparency, why create different treatments for different classes of companies.

**Cash Flows**

***Issue 16:*** *For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?*

No. It makes no sense to arbitrarily divide the tax benefits into two categories and account for them differently. Other than making work for accountants, consultants and auditors, this provides no useful information and there is no rationale for treating a portion of the tax benefit as a financing cash flow rather than a reduction of tax obligation. It is, in fact, **not** a financing cash flow and it is, in fact, a reduction of tax obligation.

**Differences between This Proposed Statement and IFRS 2**

***Issue 17:*** *Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?*

No comment on this issue.

**Understandability of This Proposed Statement**

***Issue 18:*** *The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?*

No, not even close. The proposed statement is long and complex and will require a substantial amount of time to digest and implement. It will require the use of complex mathematical models that are unfamiliar to the accounting profession and belong instead in the realm of applied mathematics and financial analysis. The audit firms will weigh in with interpretations that will add additional complexity and the costs of implementation and audit will be astronomical, all for a number which is already available in the notes, has little value, and will be backed out by every competent financial analyst to arrive at a conclusion on financial performance, risk and enterprise value.

Respectfully submitted,

Steven C. Mayer
Executive Vice President and
Chief Financial Officer

SCM:jp

June 29, 2004

By email: director@fasb.org

Financial Accounting Standards Board
Director of Major Projects
File Reference No. 1102-100
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: **Share-Based Payment, an amendment of FASB Statements No. 123 and 95**

Dear Sirs & Madams:

The Biotechnology Industry Organization (BIO) submits its views on the Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (the Exposure Draft). We appreciate the opportunity to offer comments on this significant matter.

BIO represents more than 1,000 biotechnology companies, academic institutions, state biotechnology centers and related organizations in all 50 U.S. states. The biotechnology industry, like many other growth sectors of the economy, uses broad-based employee stock option plans as an integral part of our efforts to recruit and retain highly qualified physicians, scientists and other professionals. Such plans are especially important as the industry continues to develop and commercialize its products and needs to attract these highly qualified employees in increasing numbers. The comments in this letter primarily represent the views of the small-medium size companies that represent the vast majority of our membership and who will shoulder a disproportionate cost in implementing these new guidelines if they are required.

For the reasons outlined below, BIO has serious concerns with the mandatory expensing of employee stock options outlined in the Exposure Draft.

**Part One: BIO's Opposition to the Expensing of Employee Stock Options**

**I. Mandatory expensing of employee stock options will decrease the reliability and comparability of financial statements**

We believe that the mandatory expensing of stock options will decrease the reliability and comparability of financial statements for companies in our industry. Predicting the volatility of biotechnology stocks is especially difficult due to it being event driven rather than earnings driven.

Because our industry includes a large number of small entrepreneurial companies, the historical stock price volatility in the biotechnology industry is higher than that of more mature industries due in large part to uncertainty during the regulatory product approval process. For example, the average volatility assumption for a sample of 25 public biotechnology companies was 59%, as compared to the average volatility

assumption of approximately 36% of 100 public companies surveyed by Ernst & Young LLP in 2003 across a variety of industries.

Because of the higher stock price volatility in our industry and the more extensive use of broad-based employee stock compensation programs, the impact of the adoption of the Exposure Draft will be significant. For example, the average percentage change of the Statement 123 pro forma net income (loss), as compared to the net income (loss), of a sample of 25 public biotechnology companies was a 21% decrease in net income or 30% increase in net loss, as compared to an average decrease in net income of 11% from a survey of 100 public companies surveyed by Ernst & Young LLP in 2003 across a variety of industries. Furthermore, the impact of the pro forma charges to an individual company can be even more significant. For example, the pro forma increase in the 2003 net loss for one of our industry's largest and most successful companies was 84%.

In addition, the high stock price volatility in our industry, when combined with other highly subjective assumptions, can yield an unacceptably wide range of results. While it may be useful to disclose a hypothetical charge in the footnotes to the financial statements, the inclusion of employee stock option expense in the statement of operations will result in less clarity, consistency and reliability of the financial statements. The sensitivity of the option pricing models to the significant estimates and judgments would permit two similar companies to have significant differences in the reported expenses. For example, of 25 public companies in the biotechnology industry the volatility assumption used in the calculation of the fair value of employee stock options ranged from 31% to 107%. When this wide range of volatility is applied in an option valuation model, the values assigned to the stock options can vary more than 100%. Because of the magnitude of this charge to our industry, we believe that differences in judgment may adversely impact comparability and reliability.

**II. Employee stock options do not represent an expense**

We do not believe that an employee stock option meets the definition of an expense as defined in Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements.* Specifically, we do not believe that stock options represent "outflows or other using up of assets or the incurrence of liabilities." Conversely, the exercise of a stock option represents an increase to assets by the amount of cash paid by the employee to exercise the stock option.

**III. The expensing of employee stock options will distort earnings per share**

The potential dilution that may occur with respect to employee stock options is currently reflected in the diluted earnings per share calculation. The inclusion of a cost for employee stock options in the statement of operations will result in an inaccurate "double charge" in the financial statements.

**IV. The cost required to implement a lattice model exceeds the benefit**

We do not believe that the benefits of implementing a complex lattice option-pricing model exceed its costs. As outlined in Statement of Financial Accounting Standards No. 1, *Objectives of Financial Reporting by Business Enterprises,* information provided by financial reporting involves a cost to provide and use, and generally the benefits of information provided should be expected to at least equal the cost involved.

The biotechnology industry is a growth sector and includes a large number of small entrepreneurial companies. Due to extremely long product development cycles, usually 10-15 years, and extensive costs involved in conducting clinical trials and launching a drug, the vast majority of biotech companies (over 90%) do not yet have products on the market. The adoption of a complex and difficult to implement lattice model would

impose a disproportionate administrative burden to many of these companies while they are trying to conserve cash for clinical programs. For example, a survey of thirteen public biotechnology companies in the San Francisco Bay Area with a market capitalization between $145 million and $375 million identified that the average size of the finance staff is 4.4 full time equivalent personnel. As such, it is unlikely that any company of this size would have sufficient expertise to accumulate and analyze the required historical data, such as employee exercise patterns, in order to appropriately implement a lattice model. These companies thus would be required to hire external experts to assist in the adoption of the Exposure Draft. Based upon on our inquiry of external valuation experts, we estimate that implementation of the Exposure Draft would cost small entrepreneurial companies $100,000 to $300,000 per year in external consultant costs to maintain compliance. In addition, we expect companies in our industry to incur additional internal compliance costs as well as increased external audit costs. Due the limited usefulness of this estimate to the shareholders of biotechnology companies, we strongly believe that the cost to prepare the disclosure far exceeds the benefit.

In sum, we do not support the use of limited cash resources to calculate a hypothetical non-cash charge. Rather, we believe that cash resources would better serve shareholders of companies in our industry when applied to the development of life-improving biotechnology products.

**Part Two: Specific Concerns with FASB's Proposed Amendment of Statements No. 123 and 95 (the Exposure Draft)**

In the event FASB moves forward with all or some of the expensing requirements outlined in the exposure draft, which BIO strongly opposes, we also want to raise additional concerns about how these rules might be implemented.

1. **The Exposure Draft does not provide adequate "safe harbor" on valuation and could lead to a significant increase in litigation.**

The Exposure Draft does not provide sufficient guidance to enable the finance departments of many of the companies in our industry to assign a valuation to employee stock options without undue cost. Because the potential impact of employee stock compensation expense will be material to many of the companies in our industry, it does not appear that the Financial Accounting Standards Board would endorse the use of other simplified models. According to a survey of 100 companies conducted by Ernst & Young, of the 97 companies that provided the pro forma net income and earnings per share (EPS) disclosures required by the Statements, 91 companies used the Black-Scholes formula for estimating the fair value of the options granted during 2002. Of the remaining six companies, two companies used a Binomial model. Therefore, if some form of expensing is required, at a minimum we recommend that the Exposure Draft be revised to permit the use of simplified assumptions and methodologies in a wider, and more objectively defined, set of circumstances. We also recommend that the Exposure Draft be revised to include simplified examples of how the Black-Scholes option-pricing model can be adjusted to take account of the characteristics of employee stock options that are not consistent with the assumptions of the model.

Absent clear direction from FASB on which valuation methodology companies should use, how they should be employed, and a "safe harbor" provision that protects the decisions on inputs that will undoubtedly vary from company to company, we are concerned that the current approach could result in a significant increase in litigation by groups claiming earnings were misrepresented. This concern is examined in detail in an

article by Kevin Hassett and Peter Wallison, entitled "A Troubling Requirement" that appeared in the Spring 2004 edition of the journal *Regulation*.

**II. Neither of the existing valuation models proposed by FASB adequately discounts for the unique attributes of employee stock options.**

The option pricing models contained in the Exposure Draft fail to incorporate factors unique to employee stock options, especially two critical factors that should be significantly discounted for: lack of transferability and blackout periods.

Lack of transferability affects the valuation of employee options. There is no market for employee stock options until they vest. More importantly, out-of-the-money options vested or not would have value in the eyes of a third party willing buyer if they were transferable. Therefore compared to a traded option with otherwise identical terms, the lack of transferability restriction associated with an employee stock option significantly reduces the value of the option. In fact, Dr. Jonathan Mun, author of the Crystal Ball valuation method that the binomial method is based upon, has in a recent submission to FASB (*FASB comment letter on FAS 123 Exposure Draft No. 2402*) stated, "the author's suggestion is to allow the incorporation of marketability discounts be taken by firms issuing ESOs."

Similar to the lack of transferability, blackout periods are common for employee stock options and should also be discounted. In many companies there are large numbers of employees that are blacked out from exercising stock options for "calendar" reasons. For example, executives and most finance departments are blacked-out at least two weeks prior and two weeks following quarter-ends and until after quarterly earnings releases are made.

In addition, in the biotechnology industry stock prices of individual companies are usually event driven and often fluctuate because of events like drug approvals, release of scientific data, or study delays and reporting of adverse events. During and prior to these events, companies are forced to black out teams of employees. These blackout periods restrict the number of days employees can trade their options. To accurately value employee stock options there must be significant discounts for these blackout periods.

**III. Investors in Biotechnology companies are predominately focused on "cash burn", not non-cash charges**

We do not believe that the expensing of the hypothetical non-cash cost of employee stock options will be meaningful to investors. Rather, the primary focus of investors in our companies is on the rate of "cash burn." Accordingly, by including the non-cash charge for employee stock options in earnings, it creates incentive for management to develop additional non-GAAP accounting disclosures. For example, the inclusion of non-cash stock based compensation expense in research and development on the statement of operations will obfuscate the true rate of cash research and development expenditures. We question whether this result would be consistent with the Financial Accounting Standards Board project on Financial Performance Reporting by Business Enterprises. In our opinion, this Exposure Draft will contribute to the proliferation of alternative and inconsistent financial performance measures and will undermining high-quality financial reporting, which is essential to well-informed investment decisions and efficient capital markets.

We urge you to consider whether the objectives of the Exposure Draft outweigh the significant costs that will be placed on the small entrepreneurial companies in our industry. This additional burden is overwhelming when combined with other recent sweeping regulatory requirements, such as the Sarbanes-Oxley Act of 2002. We

appreciate the opportunity to offer these comments. If you have any questions regarding this letter, feel free to contact Steve Lawton at (202) 962-9200.

Sincerely,

/s/

Carl B. Feldbaum
President
Biotechnology Industry Organization

---

**Responses of Robert H. Herz**
**Chairman**
**Financial Accounting Standards Board**
**to Questions from the Honorable Jim Davis**
**Committee on Energy and Commerce**
**regarding the July 8, 2004, Subcommittee on Commerce, Trade, and Consumer Protection Hearing entitled**
**"FASB Proposals on Stock Option Expensing"**

1. **During your testimony on July 8, 2004, before the Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection, you stated that the Financial Accounting Standards Board (FASB) believes that stock options can be valued with sufficient reliability. However, Commissioner Paul Atkins of the Securities and Exchange Commission has expressed concerns about the reliability to measure stock options. He stated that, "putting a fair value on something as complicated as long term stock options is almost an impossible task." Furthermore, Warren Buffett, Chairman of Berkshire Hathaway, who has publicly supported the expensing of stock options, stated in the May 4, 2003, edition of *Financial Times* that, "Black-Scholes is an attempt to measure the market value of options and it cranks in certain variables, but the most important value it cranks in is the past volatility of the asset involved and past volatilities aren't the best judge of value." Given the concern and debate surrounding the use of current options pricing models to measure the value of employee stock options, please explain in detail why the FASB believes that stock options can be measured with sufficient reliability?**

   As your question indicates, in developing the Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"), the Financial Accounting Standards Board ("FASB" or "Board") concluded, after extensive research and analysis and public deliberations, that estimating the fair value of employee stock options based on currently available valuation techniques would generally result in sufficiently reliable compensation expense amounts that would improve the comparability of financial statements. In reaching that conclusion, the Board noted that the existing use by most companies of the intrinsic value method for measuring employee stock options under APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"), has impaired and would continue to impair not only the comparability, but the relevance and reliability of financial statements by omitting a potentially significant component of the total cost of employee services. That view is supported by the July 2003 United States Securities and Exchange Commission's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* ("SEC

Study"). The SEC Study was critical of Opinion 25 and concluded that accounting standards could result in greater comparability if they were more "objectives-oriented" allowing accounting professionals to operationalize accounting treatments in a manner that best fulfills the objective of the standard and thereby best captures the underlying economic reality.

The Board's conclusion is also supported by the fact that for eight years thousands of public companies have been estimating the fair value of employee stock options, generally consistent with the approach contained in the Proposal, and have been reporting those amounts in their audited financial statements. Moreover, more than 750 companies, 120 of which represent 42 percent of the S&P 500 index based on market capitalization, have estimated and reported all of their employee stock options as an expense in their audited and certified financial statements generally consistent with the Proposal's approach.

In addition, effective January 1, 2004, many Canadian companies, including over 500 technology companies, were required to expense all employee stock options based on a measurement approach generally consistent with that contained in the Proposal. It is our understanding that the implementation of that standard has to date gone very smoothly without significant concerns being raised by preparers, auditors, or users of those financial statements about the reliability of the reported amounts. Beginning in 2005, International Financial Reporting Standards will require thousands of other foreign companies in over 90 countries around the world to do the same.

Many, if not most, valuation experts and many other parties that have studied the issue, including Federal Reserve Chairman Alan Greenspan, the Congressional Budget Office, and the CFA Institute (a global professional association whose membership includes 57,000 financial analysts) agree that employee stock options can be reliably valued under the Proposal's approach. It is widely acknowledged that far more complicated financial instruments, including long-dated and complex derivatives, and convertible bonds containing long-dated options, are valued in the marketplace daily and routinely reported by companies in their audited and certified financial reports.

Most accounting estimates that are currently reported in audited and certified financial reports are not mechanical calculations but require that companies use appropriate measurement techniques, relevant data, and management judgment in making those estimates. It is widely acknowledged that the uncertainties inherent in estimates of the fair value of employee stock options are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, asset impairment calculations, and pensions and other postretirement benefit obligations. Moreover, the implementation guidance contained in the Proposal is far more extensive than the guidance provided in the accounting literature for the measurement of those other items. Few accrual-based accounting measurements can claim absolute reliability, but most parties, including Warren Buffett, agree that financial statement recognition of estimated amounts, including the fair value of employee stock options, that are approximately right, is preferable to the alternative—recognizing no amounts.

Finally, the Proposal's Notice for Recipients includes six issues requesting additional input on the measurement approach contained in the Proposal, including whether the Proposal provides sufficient guidance to ensure that the fair value measurement is applied with reasonable consistency. Measurement issues raised by the Proposal were also discussed at the Board's public roundtables on June 24, 2004, in Palo Alto, California, and June 29, 2004, in Norwalk, Connecticut. The many comment letters and other input received in response to the Proposal, including suggestions for potential revisions to the Proposal, will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

2. **Given the impact that expensing stock options might have on the high technology industry, why has the FASB not conducted research on the options pricing methods using volatile high technology companies to test the reliability of the models?**

The FASB conducted extensive research and analysis and public deliberations relating to option pricing methods in developing the Proposal, including soliciting and receiving input from "volatile high technology companies." Examples of some of the types of research, analysis, and input the FASB considered in developing the Proposal's measurement guidance include:

- Results of discussions with a variety of parties including the Financial Accounting Standards Advisory Council, the FASB's User Advisory Council, and many other groups representing preparers of financial reports, and auditors, and investors, and other users of financial information.
- Results of discussions with many valuation experts and compensation consultants, including those on the FASB's Options Valuation Group.
- Results of "field visits" with a number of public and private companies covering a range of industries, including high technology companies.
- Data relating to the information about employee stock option compensation contained in the disclosures of the audited and certified financial reports of companies.
- Input from the many public companies that have voluntarily elected to include the expense relating to employee stock options in determining their reported net income.
- Information and views in the many comment letters received in response to the FASB's November 2002 Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment.
- Work done on this subject, including field tests, by the FASB in the development of FASB Statement No. 123, *Accounting for Stock-Based Compensation* ("Statement 123").
- Work done on this subject by other accounting standard setters, including, as indicated in response to Question 1, the International Accounting Standards Board and the Canadian Accounting Standards Board.

As indicated in response to Question 1, the FASB has solicited and received a substantial amount of input on the measurement guidance contained in the Proposal, including input from many "volatile high technology companies." The FASB will continue to solicit input on, and research and analyze, the measurement issues and other related issues raised by the Proposal throughout the completion of the project. The input received, including suggestions for potential revisions to the Proposal, will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

3. **If the FASB does conduct research on the impact of expensing stock options on high technology companies, how do they plan on conducting such tests?**

As indicated in response to Question 2, the FASB conducted extensive research and analysis and public deliberations in developing the Proposal, including "field visits" with public and private companies covering a range of industries, including several high technology companies. Those field visits included inquiries focusing on the costs of implementing the Board's tentative measurement guidance. The

Board concluded that the field visits provided them with a sufficient understanding of the potential costs and benefits and implementation issues raised by the tentative measurement guidance necessary to support the issuance of the Proposal for public comment.

The FASB did not conduct "field tests" in developing the Proposal. The Board generally uses the term field tests to describe a formal application of a proposed approach or proposed Statement by various companies to their particular enterprise. The participating companies are generally provided with a description of the proposed approach (if a proposed Statement has not been issued) and are asked to apply that approach either to current transactions or retroactively to one or more prior years.

The FASB has generally conducted field tests in those circumstances in which the Board was developing an entirely new principle or guidance. For example, as indicated in response to Question 2, the Board conducted field tests in the development of Statement 123.

As indicated above in response to Questions 1 and 2, the FASB will continue to solicit input on, and research and analyze, the issues raised by the Proposal throughout the completion of the project. The input received, including suggestions for potential revisions to the Proposal, will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

W. J. "BILLY" TAUZIN, LOUISIANA
RALPH M. HALL, TEXAS
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FRED UPTON, MICHIGAN
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JOHN SULLIVAN, OKLAHOMA

BUD ALBRIGHT, STAFF DIRECTOR

ONE HUNDRED EIGHTH CONGRESS

U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515–6115

JOE BARTON, TEXAS
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CHARLES A. GONZALEZ, TEXAS

August 4, 2004

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856

Dear Mr. Herz:

On July 8, 2004, the Subcommittee on Commerce, Trade, and Consumer Protection held a hearing entitled "FASB Proposals on Stock Option Expensing." I am writing to you to ask that you follow up on an important question that arose in those proceedings.

The method for establishing a fair value for the stock options to be expensed has emerged as the central issue of the debate surrounding the Board's exposure draft. At the hearing, you were asked whether FASB had done or was aware of any studies of actual expensing using either of the proposed methodologies (see attached unofficial transcript pages 98-100). I believe that there have been a number of published studies, academic and otherwise, on those companies that have voluntarily adopted fair value accounting for employee stock options. Please provide a list of those studies for the record, and, if available, copies also for our review. Please also provide a clearer explanation of the grant date approach. Do studies about the value of the underlying stock at the date an option is exercised have any relevance to the estimation of the grant date fair value of an option? Please explain.

Because we wish to include your answer in the printed record of this hearing, please respond no later than Wednesday, August 18, 2004. If you have any questions about this request, please have your staff contact Consuela Washington, Senior Minority Counsel, at 202-225-3641.

Sincerely,

JOHN D. DINGELL
RANKING MEMBER

Attachment

cc: The Honorable Joe Barton, Chairman
Committee on Energy and Commerce

The Honorable Cliff Stearns, Chairman
Subcommittee on Commerce, Trade, and Consumer Protection

The Honorable Jan Schakowksy, Ranking Member
Subcommittee on Commerce, Trade, and Consumer Protection

The Honorable Jim Davis, Member
Subcommittee on Commerce, Trade, and Consumer Protection

**Financial Accounting Standards Board**
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ROBERT H. HERZ
Chairman

VIA HAND DELIVERY

August 18, 2004

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515-6115

Dear Representative Dingell:

Thank you for your letter of August 4, 2004, following up on my testimony at the July 8, 2004, Subcommittee on Commerce, Trade, and Consumer Protection hearing entitled "FASB Proposals on Stock Option Expensing."

Your letter includes several requests for additional information to be included in the printed record of the hearing.

List of Studies

First, your letter requests that I provide a list of studies "on those companies that have voluntarily adopted fair value accounting for employee stock options." The following is a list of studies and other materials that have been brought to my attention relating to the topic:

- Bear Stearns. "House Votes to Block FASB Stock Options Proposal, but DOA in Senate; Voluntary Expensers Increase to 753." *Equity Research: Accounting/Taxation,* July 20, 2004. A detailed listing of companies voluntarily expensing stock options under the fair value method.

- Christian, Cal. "Expensing Stock Options: What Will Be the Effect on Financial Institutions?" *Bank Accounting & Finance*, Volume 16, Issue 6, October 2003. A review of first quarter 2003 10-Q earnings and stock option expense for members of Financial Services Forum, a group representing 21 of the nation's largest financial companies that made a joint statement supporting the voluntary expensing of all employee stock options in August 2002.

- Deshmukh, Sanjay, Keith M. Howe, and Carl Luft. "Stock Options Expensing and Corporate Governance." *Strategic Finance,* July 1, 2004. Article describing study of 122 firms that made expensing announcements between July and December 2002. Results "suggest the expensing of employee stock options is more likely to occur in firms that are more transparent and with more closely aligned interests between managers and investors" and "imply that expensing of stock options is more likely to occur in firms that practice good governance."

- Garg, Ashish, and William T. Wilson. "Expensing Stock Options: What Do the Markets Say?" *The Journal of Employee Ownership Law and Finance,* Volume 15, No. 4, Winter 2003. Also in Ernst & Young's *Cross Currents,* Fall 2003. A study examining investor reactions to 54 companies' announcements to voluntarily expense all employee stock options made between July 8, 2002 and January 16, 2003. Results showed no significant impact on share price and a somewhat higher than normal shareholder return for companies with larger expenses.

- Grund, Michael, and Richard N. Ericson. "Options Expensing Announcement Has No Impact on Share Price." Towers Perrin, March 31, 2004. Available at www.towersperrin.com/hrservices/global/default.htm Event study that includes 335 companies that announced voluntary expensing between April 2, 2001, and August 14, 2003. After tracking share prices on the announcement date and 150 days before and after, Towers Perrin found share performance the same, on average, as the share performance of the 900 companies comprising S&P's 500 and mid-cap 400 indexes.

- Robinson, Dahlia, and Diane Burton. "Discretion in Financial Reporting: The Voluntary Adoption of Fair Value Accounting for Employee Stock Options." *Accounting Horizons,* Volume 18, No. 2, June 2004. Authors' investigation of 102 firms announcing voluntary expensing of all employee stock options between July 2002 and September 12, 2002 suggests: (1) the decision to expense using the fair value method is value relevant; (2) adopters stand to benefit the most by improving the market's perception of their accounting reports; and (3) the impact of employee stock option expense is economically significant for 43 percent of the adopters.

As requested, I have attached a copy of each of the above referenced materials for your review.

Grant Date Approach

Second, your letter requests a "clearer explanation of the grant date approach," and whether any "studies about the value of the underlying stock at the date an option is exercised have any relevance to the estimation of the grant date fair value of an option."

Under the grant date approach, the expense of employee stock options is measured at fair value when the options are granted by the employer to the employee. The fair value estimate of the compensation cost is based on the employer's stock (and other pertinent factors) that exists at the grant date. The expense amount is recognized over the time (the contractual vesting period) during which the employee renders services to the firm in exchange for the compensation that the options represent.[1]

The transaction essentially comprises two separate events: (1) the granting of an employee stock option, which conveys a specific amount of compensation to be earned by the employee over the vesting period, and (2) subsequent gains and losses from changes in the option's fair value. The initial grant date fair value of the option is a compensation cost to the employer and reported in the employer's income statement with other operating expenses. In contrast, any subsequent gains and losses in the fair value of the option represent a transfer of wealth between the employer's existing shareholders and the employees who were recipients of the options.

As Federal Reserve Chairman Alan Greenspan has explained:

> To assess the cash equivalent of the option, only the market value of the option at the time of the grant matters. Subsequent changes in the value of the option are not relevant to the exchange of labor services for value received, just as future changes in the purchasing power of *cash* received for services rendered do not affect the firm's compensation costs.[2]

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[1] The approach contained in the FASB Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraph 10, is often described as a "modified grant date approach," because, under the Proposed Statement, compensation cost would generally be based only on the grant date fair value of the awards that the company expects to vest. The expense would be recognized over the vesting period and reduced for any actual forfeiture of options that may occur during that period. Thus, under the Proposed Statement's modified grant date approach, the total amount of compensation expense recognized for employee stock options granted would exclude the costs associated with those options that do not vest.

[2] Remarks by Chairman Alan Greenspan, "Stock Options and Related Matters," at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (via satellite) (May 3, 2002), pages 3 and 4.

Similarly, in its recent examination of the accounting for employee stock options, the Congressional Budget Office concluded:

> - If firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' reported net income will be overstated.
>
> - Changes in the value of employee stock options after they have been granted as well as the exercising of those options are irrelevant to a firm's income statement because they affect shareholders directly, not the firm itself. Specifically, they transfer wealth from existing shareholders to holders of employee stock options.[3]

Thus, as indicated in my testimony, any studies about the fair value of the underlying stock at the date an employee exercises a stock option may have relevance in estimating the amount of wealth transferred between the employer's shareholders and employees, but have no relevance in estimating the grant date fair value of employee stock options.

It should be noted that the grant date approach described in the Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, is generally consistent with the approach long used for reporting other forms of compensation costs and for the reporting of other forms of equity-based transactions. The approach is also currently being used by the more than 750 companies that file with the United States Securities and Exchange Commission and are voluntarily expensing all employee stock options, and the thousands of Canadian companies that were required to expense all employee stock options beginning January 1, 2004.

Finally, the grant date approach has also been recently adopted by the International Accounting Standards Board in IFRS 2, *Share-based Payment*. IFRS 2 will require expensing of all share-based payments, including employee stock options, by companies in over 90 countries around the world beginning January 1, 2005.

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[3] The Congressional Budget Office, "Accounting for Employee Stock Options," Section 2 (April 2004), pages 1 and 2.

If you have any additional questions or comments, please feel free to contact me directly or our Washington, DC representative, Jeff Mahoney (703-243-9085).

Yours truly,

Robert H. Hery

Attachments

W.J. "BILLY" TAUZIN, LOUISIANA
RALPH M. HALL, TEXAS
MICHAEL BILIRAKIS, FLORIDA
FRED UPTON, MICHIGAN
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C.L. "BUTCH" OTTER, IDAHO
JOHN SULLIVAN, OKLAHOMA

BUD ALBRIGHT, STAFF DIRECTOR

ONE HUNDRED EIGHTH CONGRESS

**U.S. House of Representatives**
**Committee on Energy and Commerce**
**Washington, DC 20515–6115**

JOE BARTON, TEXAS
CHAIRMAN

August 9, 2004

JOHN D. DINGELL, MICHIGAN
HENRY A. WAXMAN, CALIFORNIA
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RICK BOUCHER, VIRGINIA
EDOLPHUS TOWNS, NEW YORK
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TOM ALLEN, MAINE
JIM DAVIS, FLORIDA
JAN SCHAKOWSKY, ILLINOIS
HILDA L. SOLIS, CALIFORNIA
CHARLES A. GONZALEZ, TEXAS

The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

On July 8, 2004, the Subcommittee on Commerce, Trade, and Consumer Protection held a hearing entitled "FASB Proposals on Stock Option Expensing." We are writing to you to request your agency's response to an important question that arose in those proceedings.

Mr. Jeffrey Skilling, former Enron President and CEO, testified before the Senate Committee on Commerce, Science, and Transportation on February 26, 2002: "There are cases where you can use equity to impact your income statement. And the most egregious, or the one that's used by every corporation in the world is executive stock options. And as a matter of fact, I think FASB tried to change that, and you introduced legislation in 1994 to keep that exemption. And essentially what you do is you issue stock options to reduce compensation expense and therefore increase your profitability."

There have been press reports about various alleged stock options abuses. See, e.g., "SEC Probes Options Grants Made As Company News Boosts Stock," Wall Street Journal, Tuesday, March 30, 2004. However, when the witnesses at the above-referenced hearing were asked for examples of stock options abuses or scandals, none of the witnesses was able to produce an example (see attached transcript pages 89, 90, and 111).

Accordingly, we request your response to the following questions. Are there examples of stock option scandals that have defrauded investors? What examples of abuses or scandals attributed to the current accounting treatment of employee stock options are you aware of? What risks do investors bear under the current accounting standard for stock options? How would the FASB's proposed accounting standard changes address these problems?

Because we wish to include your answers in the printed record of this hearing, please respond no later than Monday, August 16, 2004. If you have any questions about this request, please have your staff contact David Cavicke, Chief Counsel (202-225-2927) or Consuela Washington, Senior Minority Counsel (202-225-3641) of the Committee on Energy and Commerce.

The Honorable William H. Donaldson
Page 2

Sincerely,

JOE BARTON
CHAIRMAN

JOHN D. DINGELL
RANKING MEMBER

CLIFF STEARNS
CHAIRMAN
SUBCOMMITTEE ON COMMERCE,
TRADE, AND CONSUMER PROTECTION

JANICE D. SCHAKOWSKY
RANKING MEMBER
SUBCOMMITTEE ON COMMERCE,
TRADE, AND CONSUMER PROTECTION

Attachment

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 23, 2004

The Honorable Joe Barton
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Barton:

Thank you for your August 9th letter regarding the proposed changes in the accounting for employee stock options. Your letter indicates that witnesses at a July 8, 2004 hearing held by the Subcommittee on Commerce, Trade, and Consumer Protection were unable to respond to a request for examples of stock options abuses or scandals that have defrauded investors. You have asked me whether the Commission is aware of such abuses or scandals. You also have asked me what risks investors bear under the current accounting standard and how the changes proposed by the Financial Accounting Standards Board would address those risks.

Employee stock options can be a valuable tool for the recruitment, retention and motivation of talented employees and are often especially important to small and recently created corporations. Nonetheless, as noted in your letter, witnesses at congressional hearings, members of the press, and others have indicated that, when the distribution of stock options to members of senior management becomes abusive, there can be adverse consequences for investors.

Although we are aware of a few studies, there is relatively little empirical research in this area. One instance of such abusive practices might have occurred at WorldCom. In the Corporate Monitor's report to the court, former SEC Chairman Richard Breeden noted, "The executive compensation practices of the old WorldCom made a mockery of shareholder interests and eroded the legitimacy of the Company's governance practices.... The enormous compensation paid to these individuals [Messrs. Ebbers and Sullivan] was in part a reflection of massive distribution of stock options, along with aggressive use of cash .... The aggressive personal enrichment attitudes reflected in the Company's compensation practices with regard to Ebbers and Sullivan were so corrosive of responsible behavior that they may have implicitly created a climate conducive to the fraud that occurred."

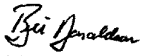
It is important to understand, however, that the primary purpose for the FASB's reexamination of the accounting for employee stock options is not to alter corporate compensation practices. It is to reduce the risk that the results of those practices may not

be reflected consistently and clearly in companies' financial results. Shareholders, lenders and other participants in our capital markets depend on the integrity of financial statements every day. The cumulative cost to those groups when investment decisions are based on financial information that may not reflect a significant cost of doing business is a very real harm.

The Commission's overriding interests are to ensure that the FASB uses an open and impartial process to develop a standard and that the final standard is within a range of reasonable alternatives that serves and protects investors. I have described the basis for our position in the enclosed letters to Congressmen Kanjorski, Dingell and Wolf and Senator Frist, which I hope you will find informative.

I appreciate your interest in this issue and would be happy to discuss it with you if you have any questions or would like additional information.

Sincerely,



William H. Donaldson
Chairman

Enclosures

Substantially similar letters to:

The Honorable John D. Dingell, Ranking Member
The Honorable Cliff Stearns, Chairman, Subcommittee on Commerce, Trade, and Consumer Protection
The Honorable Janice D. Schakowsky, Ranking Member, Subcommittee on Commerce, Trade, and Consumer Protection