

Welcome to Equilar's monthly newsletter. We would like to take a brief moment to highlight key trends in executive compensation and update you on Equilar activities.

▶ EQUILAR ANNOUNCES RESULTS OF OPTION VALUATION STUDY FOR CEOs AT S&P 500 COMPANIES

Given the ongoing debate on how to value employee stock options, we decided to analyze how companies implement Black-Scholes and compare their calculated values of CEO option grants against ours. Those familiar with Black-Scholes recognize that it is a highly complex formula that requires a series of detailed calculations. Consequently, minor changes in how it is implemented can have a significant impact on the ultimate value of an option.

Since Black-Scholes was designed to calculate the value of exchange-traded options, a number of companies make modifications in implementation to account for the illiquidity and vesting restrictions associated with employee options. Since guidelines currently do not exist, companies have the liberty to make their own modifications and disclose them in the footnotes of their annual proxy filings.

To allow for an accurate, "apples to apples" comparison across companies, we calculate Black-Scholes values for all companies the same way. Several of our key assumptions include:

- Term of option – Full term of the option.
- Volatility – Historical three-year stock price volatility measured on a daily basis from the date of grant.
- Risk free rate – Treasury bond instrument of same duration as the option term.
- Dividend yield – Actual dividends paid in prior four quarters divided by stock price on grant date.

We compared our calculated grant date present value against the disclosed Black-Scholes values for 208 CEOs at companies in the S&P 500 in instances where the values were calculated by the company. The remaining CEOs within the S&P 500 either (i) were not awarded options in 2002 or (ii) estimated the value of their option grants using the 5%/10% annual appreciation method. Here are several key findings:

- The median value for the option values disclosed in the proxy filings was 69.1% of our calculated values (in other words, values disclosed in proxies were at a 30.9% discount to the values calculated by Equilar). The primary differences in methodology were:
 - Option terms assumed in the proxy filings were shorter in duration than those assumed by Equilar. In certain extreme situations, companies assumed an option term of three years even though the options had an actual term of ten years.
 - Stock price volatilities tended to be lower than Equilar's. For example, one company assumed a volatility of 30% when we calculated a 3 year historical volatility of 62.4%, thereby reducing the option value by nearly 29.8% (keeping all other variables constant).
- As FASB moves this fall toward additional clarification regarding option expensing, this will significantly reduce the wide range of assumptions currently being utilized by various companies. This is reflected in the range of disclosed option values, from as high as a 15% premium to our calculated values to a 70% discount.

- The following table reflects the disparity in option values and provides a distribution indicating the number of CEOs that fall into each of the valuation ranges:

	Number of CEOs	Percentage of Total
Premium to Equilar values	14	6.7%
0-10% discount	13	6.3%
10-20% discount	25	12.0%
20-30% discount	48	23.1%
30-40% discount	50	24.0%
40-50% discount	39	18.8%
Over 50% discount	19	9.1%

- Another interesting observation is the relationship between the median disclosed value of CEO option grants and whether they were valued at a premium or discount to Equilar calculated values. In other words, the largest CEO option awards tended to be the most aggressively valued (greatest discount to Equilar calculated values):

	Median Option Grant Value
Premium to Equilar values	\$1.2MM
0-10% discount	\$2.7MM
10-20% discount	\$2.5MM
20-30% discount	\$5.6MM
30-40% discount	\$5.0MM
40-50% discount	\$5.7MM
Over 50% discount	\$6.4MM

- There were a variety of reasons given to explain how companies arrived at their option values. Here are examples of some of the adjustments made to reduce the Black-Scholes value of option grants. This sample shows the wide latitude through which companies can disclose option values today:
 - “adjusted for risk of forfeiture in light of a company-wide turnover rate of 20%”
 - “a reduction of 25% to reflect the probability of forfeiture due to termination of employment prior to vesting and the probability of a shortened option term due to termination of employment prior to the option expiration date.”
 - “option term of three years” for options expiring ten years later.
 - “volatility of 30.0 percent” (vs. 62.4% as calculated by Equilar based on daily volatility three years prior to the date of the grant)

Equilar is committed to providing the most accurate and objective calculation of the value of option grants. After FASB makes its final recommendations later this year, we will ensure that these modifications are reflected in our methodology. If you have any additional questions, please feel free to contact us at 650.286.4512.

▶ EQUILAR IN THE NEWS

- [Mega Options, Mega Losses](#) (Louis Lavelle, *Business Week*, June 23, 2003)
- [Hancock's D'Alessandro Hits Jackpot: Graef Crystal \(Update1\)](#) (Graef Crystal, *Bloomberg*,

June 18, 2003)

- [CEOs pay the price for firms' sagging profits](#) (Aaron Elstein, **Crain's New York Business**, June 16, 2003)
- [Kissing options goodbye](#) (Rochelle Garner, **Electronic Business**, 6/15/2003)
- [Did Home Depot Hammer Shareholder Wealth?:](#) (John Wasik, **Bloomberg**, June 9, 2003)
- [Fading Pay](#) (Linda Punch, **Credit Card Management**, June, 2003)
- [Sea Change?](#) (Brent Snavely, **Crain's Detroit Business**, May 26, 2003)
- [Chicago's highest-paid CEOs](#) (Crain Communications Inc., **Crain's Chicago**, May 26, 2003)
- [Chicago's highest-paid non-CEOs](#) (Crain Communications Inc., **Crain's Chicago**, May 26, 2003)
- [MARKET WATCH; The Rules on Bosses' Pay Seem Written With Pencil](#) (Gretchen Morgenson, **The New York Times**, May 25, 2003)

Members of the press or interested members of the public should feel free to contact us at press@equilar.com. We would be happy to help provide data and analysis to assist you in your story.

▶ EQUILAR ON THE ROAD

Over the next month, Equilar will be appearing at the following venues:

- July 9th - 11th - International Corporate Government Network (ISGN, Amsterdam)
- July 24th - 25th - NASPP (San Francisco, California)

▶ CONTACT EQUILAR

If you would like to learn more about Equilar and how we can help you, please contact us by phone (877.441.6090), e-mail (support@equilar.com), or visit us on the Web at www.equilar.com.

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