A methodology proposal for Stock Market Reactions to Expensing Stock Option Compensations

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Stock options are very controversial financial instruments and new disputes arise regarding their introduction into expenses. In this paper we specifically consider the impact of stock option compensation recognition on the stock returns. The fact that there are early adopters of the new regulation to come allows us to run an event study to analyze people reactions to expensing. As these compensations are already provided by all the firms in the footnotes of their financial statements their values should be already included in the price. However we expect that their recognition will be accompanied by negative abnormal returns providing evidence for momentum at the date of the announcement and a reverse effect on a longer horizon.

Keywords: stock options compensations, SFAS 123, event study

JEL: C13, C32, C51, C52

Motivation and proposal

“Well, among the many lessons in the Enron scandal is that stock options don’t always match the same interests as those of shareholders. Enron executives walked away with tens of millions of dollars. Enron shareholders have nothing. All of this has put new urgency into the debate about whether companies should have to declare options as an expense.”

Employee stock options are contracts that give the employee the right to buy a share of stock at a prespecified “exercise” price for a prespecified term. Most employee stock options expire in ten years and are granted with an exercise price equal to the market price on the date of grant.

According to Hall and Murphy (2003) the main argument in favor of stock option plans is that they give executives a greater incentive to act in the interests of shareholders by providing a direct link between realized compensation and company stock price performance. In addition, offering employee stock options in lieu of cash compensation allows companies to attract highly motivated and entrepreneurial employees and also lets companies obtain employment services without (directly) expending cash.

Finally, stock options encourage executive risk taking, which can mitigate problems with executive risk aversion.

1 Transcript of CNN Money line with Lou Dobbs, 4/5/02

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But the incentives provided by stock options have also been criticized. The recent accounting scandals at Enron, WorldCom, Global Crossing and other companies have been linked to excessive risk taking and an excessive fixation on stock prices, both allegedly caused by the escalation in option grants. Moreover, these scandals have focused attention on problems with current accounting practices, which in turn has opened a debate on the accounting treatment of employee stock options.

They are currently only required to be reported in the footnotes of U.S. company financial statements. But FASB has proposed requiring companies to expense them, which means deducting them from profits, starting next year.

Proponents of expensing options argue that expensing will generate more informative financial statements and improve the credibility of reported earnings. They also consider that abuse of stock options contributed to corporate scandals in recent years.

Opponents of expensing worry that expensing will cause companies to grant fewer options, especially to lower-level employees, which in turn will “destroy the engine that fueled the economic growth” of the 1990s.

This debate may have fuelled enough discussions so that the opinions concerning the impact of expense recognition are very controversial. If the options are disclosed in a footnote in the financial statements then maybe they are priced by the market at the corresponding value. Their introduction into expenses should not allow for significant abnormal returns. Still, people usually do not pay the same attention to footnotes as recognized expenses and this may develop into negative returns at the moment of the options recognition. The impact is interesting.

A few issues deserve attention with respect to these events.

Thus, it is interesting that most of the early adopters evaluate option compensations using the intrinsic value as part of what could be considered a wait-and-see approach to FASB developments. The new act is expected to provide beneficial transition rules, which will not be granted to the early adopters. However the companies will be required to provide retrospective information concerning the stock based compensations at the same standards for all awards granted after 15 December 1994. Thus the cost of providing this information is different from company to company with respect to the model used, the policy of being an early adopter or not or the time since when the first stock based compensations were granted.

Another issue is that the new FASB rule will only permit the non-public companies to use the intrinsic evaluation method and will provide more information concerning the computation of the fair value (Black&Scholes or binomial model). For the moment, a lot of the early adopters undertook this approach so the effect of the difference between the two models might be perceived at the moment of the disclosure.

As such, we are entitled to expect different responses to the disclosure of different firms.

The modification of SFAS 123 that will occur soon, determined some companies to be voluntary adopters of these modifications1. This event gives us the possibility to develop our study in the following way.

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1 A document issued by Melon provides information according to which at the beginning of 2004 more than 360 companies have voluntarily adopted the current SFAS 123 expensing treatment. A great deal
The objective of this paper is to analyze the effect of stock-based compensations on the stock returns at the expensing announcement date. People may react differently to information exhibited in the financial statements as opposed to information which is recognized. Remarkably a certain pattern in the evolution of abnormal returns may provide evidence about the fact that market participants treat this information differently and we may find the psychological effects of overreaction and correction. The results may provide a possible forecast for the effects which may be perceived at the introduction of the new regulation.

The patterns revealed by the event study may also provide evidence that people have more confidence in the recognized information. We still expect to observe a movement in the price at the moment of the first stock-based compensation disclosure. These two different movements in the market can provide evidence for the behavioral anomalies but also will show that the market has different perceptions regarding the information it receives. The existence of a significant reaction to the second information may show us how noisy the first reaction was. It should be perceived as a correction reaction – people do not trust the first information anymore and they are rethinking the valuation (even if the value is the same).

First, we examine if the option compensations have negative effects on the market value of the companies. Stock-based compensations are meant to induce managers to engage in more risky projects and as such the market may account for the risk shifting. Price reductions which could allow for future positive returns may be encountered at the moment when the option disclosure was done for the first time in the footnotes of the financial statements. In order to make this analysis we can run event studies at the earnings announcements dates when the first option compensations were disclosed. This would be after January 1995 when SFAS 123 came into force.

Second, we run an event study to measure the market response to the announcement of the recognition of the option compensation as an expense for the early adopters. From the abnormal return behaviour we try to discover the patterns which could account for the short term momentum and the long term reversal as the data will permit. We can run different event studies to account for size and industry. We should take into account the fact that the first adopters are mainly high standing companies. Their expense recognition might not have the same effect as for the followers even for the fact that they are the first adopters.

Finally, we differentiate between the reactions to intrinsic value recognition as opposed to fair value recognition and look for the same patterns. We will encounter two situations: companies which in the past used the intrinsic value to be disclosed in the footnote of the financial statements and now chose to expense the same value and companies which used the intrinsic first and now are expensing the fair value. The measurement of the market perceptions with respect to disclosed information as opposed to expensed information should be best measured by the companies in the first

of these companies is expensing the intrinsic value waiting for the new regulation to provide more information about the fair value computation technique.
situation. Anyway, the companies in the second situation may provide interesting patterns too, maybe more stable on the longer term.

The remainder of the paper proceeds as follows. The next section provides an overview of the literature. Section 3 describes the data and the research design. Section 4 deals with primary findings. Finally, Section 5 summarizes and concludes the paper.

2. Theoretical development

a. Option Compensations – evolution and motivation

According to Hall and Murphy (2003) from 1992 to 2002 the value of options granted by firms in S&P 500 increased from an average of $22 million per company to $238 million per company by 2000, failing to $141 million per company in 2002. Although the exact percentages have varied from year to year, the chief executive officer’s share of the total grant has fallen from about 7 percent of the total in the mid-1990s to under 5 percent in 2000–2002. Managers and employees below the five top executives have received an increasing share of the total grant: grants to this group have grown from less than 85 percent of the total in the mid-1990s to over 90 percent by 2002.

This reduction in option granting is sometimes explained by the fact that the recognition procedure is certain to follow very soon and the managers are decreasing the option granting.

On an analysis by industries the same authors provides evidence for a concentration of option compensations in the “new economy” sector.

Narayanan (1996) finds evidence that all cash compensation determines managers to underinvest while all stock compensation induces them to overinvest. This means that there should be a certain threshold for which the combination of the two types of compensations is the optimal. The author also finds that the greater the growth opportunities for the manager the more stock based compensations will be issued.

Ofek and Yermack (2000) found that the option compensations are differently treated by the low ownership managers as opposed to the high ownership managers. The higher ownership managers usually sell shares when they are granted new issues of options in order to reduce their overall risk. The lower ownership managers tend to keep their shares after receiving new options. We can thus conclude that there is a certain threshold up to which granting new options are increasing the managers’ incentives. This is why new restrictions on the sale of shares may be imposed by boards in order to keep their control over the managers’ incentives by means of issuing new stock based compensations.

As far as the risk policy of the manager is concerned, Carpenter proves that the manager is more inclined to look for opportunities which are determining payoffs likely to be “away from the money”. This will lead the assets prices to dramatic increases in volatility. On the other hand, when the manager holds more options then he is reluctant to bear too much risk but if the options are out of the money then the manager has incentives too take risks. Expense recognition may determine a risk shifting situation and it is interesting to understand the possible

b. Accounting for Employee Stock-based Compensation
The new project of SFAS 123 will address that lack of comparability by resolving the following main issues: (a) whether compensation paid in the form of equity instruments (and other equity based compensations – EBC arrangements) should be recognized in the financial statements and (b) how should compensation in the form of equity instruments (and other EBC arrangements) be measured in the financial statements. The ultimate goal is the establishment of one method for the recognition and measurement of EBC transactions that would be followed by all companies applying U.S. GAAP and international accounting standards.

History and Background

Opinion 25, issued in 1972, required that compensation cost for awards of share options be measured at their intrinsic value, which is the amount by which the fair value of an equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award’s intrinsic value should be measured; that criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring fixed awards’ intrinsic values at the date of grant generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, and resulted in a large amount of specialized and complex accounting guidance.

Statement 123, issued in 1995, was effective for share-based compensation transactions occurring in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the application of the fair-value-based method to fixed awards results in compensation cost being recognized when services are received in exchange for valuable equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board’s decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

At the March 12, 2003 the Board also decided that the project should be undertaken in cooperation with the IASB in order to achieve a single, high-quality accounting standard on EBC.

On March 31, 2004, the FASB issued an Exposure Draft, Share-Based Payment, that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise’s equity instruments or that may be settled by the issuance of such equity instruments. The proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, Accounting for Stock Issued to
Employees, and generally would require instead that such transactions be accounted for using a fair-value-based method.

Reasons for Issuing the Proposed Statement

There are four principal reasons for issuing the proposed Statement:

Addressing concerns of users and others - which using Opinion 25’s intrinsic value method results in financial statements that do not faithfully represent the economic transactions. Part of the FASB’s mission is to improve standards of financial accounting for the benefit of users of financial information.

Improving the comparability of reported financial information through the elimination of alternative accounting methods. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method).


International convergence.

Differences between the Proposed Statement and Current Practice

The proposed Statement would affect current practice in a number of ways, but chief among them is that it would eliminate the alternative to use Opinion 25’s intrinsic value method of accounting that was provided in Statement 123 as originally issued1.

The proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments, based on the grant-date fair value of those instruments (with limited exceptions).

The proposed Statement would affect current practice in other ways, including the measurement attribute for non-public entities, the pattern in which compensation cost would be recognized, the accounting for employee share purchase plans, and the accounting for income tax effects of share-based payment transactions.

Recognizing compensation cost in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions are accounted for similarly.

c. Related Research

The literature is silent on the potential implications of changing the financial reporting of stock based compensation expense from disclosure in footnotes to recognition.

Given this situation, we can select some research results related with the disclosure and accounting for stock option compensation.

By running a laboratory experiment from the two individual-level psychological phenomena perspective, Dietrich, Kachelmeier, Kleinmuntz and Linsmeier (2001) found that decision-makers tend to avoid cognitive effort by using information in the form in which it is presented. Their results also provided evidence for the differential valuation

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1 Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost.
of gains and losses relative to a reference point, as represented by the prospect theory value function. They showed that prices are biased until expected reserve information inferable from financial statements is repackaged in a more accessible form.

Thus, under the efficient market hypothesis we would expect prices to reflect the values of the option compensations even if they are provided in the footnotes of the financial statements. That is why a significant abnormal return at the moment of the announcement would be inconsistent with the efficiency theory and would provide evidence for misvaluation of the options.

However, the market may perceive different degrees of reliability with respect to the valuation method used. We can analyze the transition from intrinsic value under the footnote to intrinsic value on the expenses on one hand, and the transition from the intrinsic value under the footnote to fair value under the expenses on the other hand. The method which provides a higher abnormal return may be understood as the most reliable method.

Aboody and Kaznik (2000), in the paper CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures investigate whether CEOs manage the timing of their voluntary disclosures around stock option awards. They conjecture that CEOs manage investors' expectations around award dates by delaying good news and rushing forward bad news and their findings suggest that CEOs make opportunistic voluntary disclosure decisions that maximize their stock option compensation.

Some have argued against option expensing on the grounds that the Black-Scholes formula, the prevailing means of estimating option expense, is approximate. Barth, Aboody and Kaznik (2004) investigate the relation between equity market values and stock-based employee compensation expense that is disclosed but not recognized in net income under SFAS 123. They found a significant negative relation between stock-based compensation expense variable and share price. This indicates that investors view SFAS 123 expense as an expense of the firm, after controlling for benefits associated as reflected in net income, equity book value, and expected earnings growth. This also underlines the fact that, despite the large amount of discretion, managers have with respect to the estimation of SFAS 123 expense, it is sufficiently reliably measured to be reflected in investors’ valuation assessments. Their findings also indicate that SFAS 123 expenses reflect on a timely basis changes in investor-perceived costs associated with stock-based compensation.

3. Methodology and data

Sample selection

According with S&P 500, for the longest time, there were only two companies in the S&P 500 who reported stock compensation expense: Boeing and Winn-Dixie. In August 2002 Coca-Cola announced their intention to recognize all of their compensation expense according to Statement No. 123. At the middle of 2003 - there were 93 new adopters of an accounting policy that encompassed expensing. In January
2004, there were 109 companies in the S&P 500 that recognized stock compensation expense.

We will hand collect data related with stock option compensation from S&P database. In Appendix 1 we present the firms that voluntarily recognized stock option compensation as an expense. We will take the case of 93 firms that announced the adoption of this issue starting with the middle of 2003, and 109 firms for 2004. We will collect data for years 2000, 2001, 2002, 2003 and 2004. All the companies are public firms.

Research Design

In order to make the described analysis we will present the event study methodology which will be used. According to Campbell, Lo and MacKinalay (1997) we assume that security returns follow a single factor market model of the type

\[ R_{jt} = \alpha_j + \beta_j R_{mt} + \epsilon_{jt} \]

\( R_{jt} \) is the rate of return of the common stock for the jth firm on day t;
\( R_{mt} \) is the rate of return of the CRSP equally weighted index;
\( \beta_j \) is the parameter that measures the sensitivity of the stock return to the index;
\( \epsilon_{jt} \) is a random variable which is iid with mean 0 and orthogonal on the index return.

For our sample we use an estimation interval of 50 days before the announcement. We can modify the number of days if we are able to acknowledge some activity in the market prior to the event.

Then we can define the abnormal return as:

\[ AR_j = R_j - (\hat{\alpha}_j + \hat{\beta}_j R_{mt}) \]

where the coefficients \( \hat{\alpha}_j \) and \( \hat{\beta}_j \) are the estimates of the single factor market model.

The abnormal return is the disturbance term of the market model calculated on an out of sample basis. Thus, for the period surrounding the announcement date we are interested to compute the difference between the stock return as observed and the stock return as it should be according to the single factor model (feeding the model with the respective index returns for the announcement period).

In order to draw overall inferences we will aggregate the abnormal returns along two dimensions – through time and across securities.

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1 That’s about 22% of the companies in the 500; in terms of market value, they amount to nearly 38% of the entire S&P 500’s market value. It’s not quite as big as it sounds, market cap-wise: eight companies - GE, Microsoft, ExxonMobil, Citigroup, Wal-Mart, AIG, Coke and Bank of America - account for 17% of the S&P 500 market valuation.

2 The software Eventus under SAS produces average cumulative abnormal returns (CA-AR) computed from the average abnormal returns (A-AR).
\[ AAR_t = \frac{\sum_{j=1}^{N} A_{jt}}{N} \]

\[ CAAR_{t_1, t_2} = \frac{1}{N} \sum_{j=1}^{N} \sum_{t} A_{jt} \]

N – the number of events in the sample (93 in our case);

Thus, for each day t we compute across all the firms an average abnormal return (AAR(t)), which provides information about the evolution of the whole sample in each day of the analysis. The cumulative average abnormal return is the return of the cumulative abnormal return over all firms and over the whole period taken into account. This provides information about the overall performance of the stock around the disclosure announcement date.

First we compute all the cumulative abnormal returns for up to 100 days after the earnings announcement when the companies disclosed the option compensations for the first time (in the footnote of the financial statements). We expect that most of them made this disclosure around January 1995 when the regulation asked. There may be companies in the sample which made this disclosure after of prior to this event.

In order to make inferences about the momentum and reversal phenomena we have to examine the values of the significant abnormal returns. We can compute rolling correlations (for instance of 3 up to 30 days) for the abnormal returns to search for possible changes in the sign – momentum for positive correlation and correction.

Second, we remake the whole analysis at the moment of the expense recognition for all the 93 firms in the sample (50 days before and 100 days after the announcement). We then compare the cumulative abnormal returns for each day with the cumulative abnormal returns for the same days (in accordance with the announcement day) for the two events (first disclosure and recognition). If we find similar patterns then the market reaction to these events is only psychologically driven. If the markets are efficient then we should not even observe significant abnormal returns in the second case. But if they are similar then the reaction is not dependent on the information content.

Finally, in order to analyze for the change in valuation method we take only the firms which are now recognizing the options according to the fair value but used the intrinsic value in the past, when they disclosed in the footnote. We make the same comparison (we use them as a subsample and run the two event studies to obtain significant abnormal returns only for them) and hope to find different patterns. The difference in abnormal returns should account for the effects of the new method. If the markets are efficient and the fair value is a better valuation method than the intrinsic value method then the market should appreciate as positive the initiative to expense the options under this method. The new obtained value should be the correct one. We should observe certain significant abnormal movement around the announcement but no reversal on the longer term.

We could also compute the intrinsic value (as in the footnote disclosure period) at the moment of the expense and compare it with the fair value. The difference between the two values is in fact the value which determines the abnormal returns in the market.
We can compare the abnormal returns obtained in the event study at the disclosing date with the value that the returns should have in case the intrinsic value was used. The difference between the two returns (computed at a certain day after the announcement) measures people’s reaction to new event, which is not consistent with the efficient market theory.

4. Summary and concluding remarks
The objective of this paper is to analyze the effect of stock-based compensations on the stock returns at the expensing announcement date. People may react differently to information exhibited in the financial statements as opposed to information which is recognized. Remarkming a certain pattern in the evolution of abnormal returns may provide evidence about the fact that market participants treat this information differently and we may find the psychological effects of overreaction and correction. The results may provide a possible forecast for the effects which may be perceived at the introduction of the new regulation.

Comments and limitations
Contemporaneous events may influence the conclusions of our analysis. We may find events which are communicated in the same time or only a few days around the expensing announcement. Removing these impediments may reduce our sample.

Most of the early adopters made their expensing decisions only a few months ago which does not allow for a very robust analysis of the post-announcement effects. The reversals may not be present as the overreaction might have not had the time to occur yet.

People might react differently to first adopters as opposed to the others. Clearly companies consider that there are advantages for deciding to make the expense recognition before the regulation comes into force. We may observe different return magnitudes at the announcement date for the earlier adopters and maybe it would be interesting to divide the sample in 2002 (first early adopters), 2003 and 2004 early adopters in order to look at the different evolutions as the market may have learned from previous expensing events.

However such an analysis may not be very robust because the 2002 sample may be very small as opposed to the other years sample and the results are not very consistent.

The information will be rearranged in a more accessible form at the moment of the expensing. Still, the degree of accessibility may depend on the rules imposed by FASB (people may have more faith in the FASB evaluation methods) and for this reason the market may wait for the new regulation before pricing the options more accurately.

The sample is relatively small which gives us low power for regression.

Because we have a special case of the voluntarily earlier adopters of the statement, the result probably cannot be easy generalized for the new adopters. However, the cost of the adoption may play an important role for the estimation of the adoption expenses at the FASB implementation.

An analysis of stock option compensation should be differentiated by industry. It is well known that in the Information Technology field the stock option compensation
is used for all employees and represent the biggest part of the salary compensation. Because the result can be very different, we can make a different study for this category.

Statement 1481 improves the timeliness of the stock option compensation disclosure by requiring that this information to be included in the interim as well as annual financial statements. Further research can analyze the impact of different type of disclosure (annually, quarterly etc) on the firms’ market values.

As the new statement will require companies to retroactively provide fair values for the stock option compensations a wide database (containing information based on the same computation methods) will be available for further research.

References:


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1 FABS has published Statement 148, Accounting for Stock-Based Compensation – Transition and Disclosure, which amends FASB 123, Accounting for Stock-Based Compensation; this Statement 148 is effective for fiscal years ending after December 15, 2002. It provides alternatives methods of transition for a voluntary change to the fair value based method of accounting for stock based employee compensation and requires more prominent and more frequent disclosures in financial statements.
Appendix 1

S&P 500 observed three ways the firms could have chosen to adopt expensing right now, before any standard makes it required - light, prospective, and full strength. The "light" adopters will recognize expense only for the new options they issue going forward; they’ll ignore any expense related to the value of any unvested options on hand at the time they go to an expensing policy. No restatement of past earnings, either. This is the gentlest policy on a firm’s forward earnings, and the one that 92 of the firms chose (naturally). "Prospective" adopters go the same route as the light adopters with one difference: they incorporate the compensation expense tied to the value of unvested options still outstanding at adoption time into their forward earnings. (Still no restatement.) Six companies chose this method. "Full strength" adopters build the same kind of expense figures into their forward earnings as the prospective adopters - but they restate their past earnings whenever they’re presented. Their income statements should read just like the pro forma stock compensation footnotes they’ve been presenting for the last seven years - all costs in. Eight of the firms chose this option. Huntington Bancshares - has not yet announced what transition method they’ll adopt.

Below, the companies grouped by their method of adoption.

**Light Adopters (Purely prospective, new options only)**

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*Prospective Adopters (New options, value of unvested options in existence)*
- Ashland
- Chubb
- Coca-Cola
- Ford
- MBIA
- Sunoco

*Full Strength Adopters (New options, value of unvested options in existence, and restatement)*
- BellSouth
- Cummins
- Lincoln
- Microsoft
- SBC
- Tenet
- U.S.
- Wal Mart Stores
- National
- Communications
- Healthcare
- Bancorp