Stock Options Expensing: Evidence from Shareholders' Votes*

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Abstract

In the 2003 and 2004 proxy seasons the Securities Exchange Commission allowed shareholders' proposals to expense employee stock options to be voted upon at the annual meeting. We analyze the determinants of shareholders' votes for a sample of 107 firms. We hypothesize and find that votes *for* expensing are higher in firms with perceived excessive option compensation and lower expected earnings impact from expensing. Voting support is also related to ownership. In particular, insiders' ownership is positively associated to votes *against*, but is associated with *votes for* from non-insider shareholders. Institutional investor ownership is associated with votes *for* expensing, except in cases where institutional investors have potential conflicts of interest with management. Finally, votes *for* are higher in firms with higher interest coverage, higher leverage, higher governance concerns, and lower returns.

JEL Classification: G34, J33, M41, M52.
Keywords: Stock Option Expensing; Executive Compensation; Shareholder Activism; Corporate Governance

* The first two authors contributed equally to the paper. We thank Yonca Ertimur, Stuart Gillan, Santhosh Gowda, Paul Healy, Raffi Indjejikian, Bjorn Jorgensen, CNV Krishnan, Paul Laux, Carol Marquardt, Greg Miller, Partha Mohanram, Volkan Muslu, Edward Riedl, Jonathan Rogers, Joshua Ronen, Ingrid Vargas, and participants at the New York University and Case Western Reserve University workshops, the 2004 Annual Eastern Finance Meeting, the Corporate Reporting and Governance Conference (California State University), the 2004 Annual AAA meeting, the 2005 FARS Mid-Year Meeting and the 15th Annual Conference on Financial Economics and Accounting for their comments and suggestions. We also thank Brian Bushee for providing his classification of institutional investors, John Core and Wayne Guay for providing their industry classification and William Greene for advice on econometric issues. Special thanks to Ed Durkin, Director of Corporate Affairs Department at the United Brotherhood of Carpenters and Joiners of America (UBCJA) for extensive conversations on UBCJA's activity. All errors remain our own.

"Every time there is another majority vote, it is a step in the direction of mandating expensing"
(Institutional Shareholder Services, Business Week, May 27, 2003)

"The Board's conclusion that many users of financial statements support recognition of the cost of employee services received in exchange for share options…was confirmed in a number of ways, including […] numerous nonbinding shareholder resolutions in which both institutional and individual investors urged entities to adopt Statement 123's fair-value-based method for recognition purposes"
(Statement of Financial Accounting Standards No.123R, December 2004)

1. Introduction

In December 2002, the Securities Exchange Commission (S.E.C.) decided to allow shareholder proposals requesting the expensing of employee stock options (ESO) to be voted upon at annual meetings. This was the first time that the S.E.C. allowed shareholders to vote on an accounting matter.[1] This decision came in the wake of the collapse of the technology sector and the emergence of a number of high profile accounting scandals. As these events unfolded, the accounting treatment for ESO, which allowed firms not to expense the cost of Employee Stock Options in their income statements and instead disclose it in the financial statements' footnotes,[2] became the target of strong criticism. In particular, investors, capital market intermediaries, and legislators argued that lack of ESO expensing had led to excessive option-based compensation (e.g. Bodie et al. 2003). In turn, they claimed, excessive ESO created perverse incentives to (a) time opportunistically option grant dates, and (b) inflate reported earnings, ultimately resulting in accounting frauds and restatements. In this environment, the

[1] In general, under Rule 14a-8(i)(7) of the Securities Exchange Act of 1934, shareholder proposals dealing "with a matter relating to the company's ordinary business operations" – such as the choice of accounting methods – can be excluded from the proxy statements. Based on this rule, the S.E.C. initially let firms exclude ESO expensing proposals, but then in December 2002 reversed its position, on the ground that the accounting treatment of ESO had become a "social policy" issue and, as such, was not subject to the ordinary business rule.

[2] In 1993, a Financial Accounting Standards Board's (FASB) exposure draft proposing the expensing of ESO based on their fair values at grant date had met strong political opposition and resulted in the issuance in 1995 of the Statement of Financial Accounting Standards No.123 (SFAS 123), which essentially allowed firms to choose between recognition and disclosure of the ESO expense.

Financial Accounting Standards Board reconsidered the accounting treatment for ESO, and eventually issued rule SFAS No. 123R mandating all companies to expense ESO (see Appendix 1 for a description of the events that led to this mandate).

In this study we provide evidence on shareholders' views on ESO expensing by examining the voting outcome of these proposals at a sample of 107 firms. In particular, we hypothesize and find that votes in favor of ESO expensing are positively related to the magnitude of perceived excessive CEO option compensation, suggesting (at least some) shareholders expect that expensing ESO will discipline the use of option-based compensation. But votes in favor of ESO expensing are negatively related to the expected earnings impact of expensing ESO, consistent with (some) shareholders fearing that expensing ESO will have a negative impact on the stock price. We also distinguish the reaction from different shareholder types and find that:

(i) insiders vote against ESO expensing, but insider ownership is positively related to votes cast in favor of ESO expensing by *non-insider* shareholders, possibly due to the perception that higher insider ownership exacerbates the problems associated with excessive option compensation;

(ii) on average, institutional investors support ESO expensing, regardless their investment horizon (i.e. "long-term value" oriented versus "short-term earnings" oriented); however, once we partition them based on their potential for conflicts of interest (i.e. business dealings with their portfolio firms), we find consistent support for ESO expensing only from institutional investors less likely to have conflicts of interest.

Support for ESO expensing is also related to a number of control variables: it tends to be higher in firms with lower stock returns, firms with higher leverage and interest coverage ratios, and firms with higher percentage of votes withheld from director re-elections, consistent with

past performance, contracting costs, and governance concerns playing a significant role in shareholders' voting decisions. The above results are robust to the Heckman two-step correction, were we control for selectivity bias. We find that firms targeted by shareholder activists are large, mostly from the S&P 500 index, but cover a broad range of industries. Relative to other S&P 500 firms, targeted firms are still significantly larger and tend to have somewhat higher levels of dilution and CEO option holdings.

Our work contributes to the literature on ESO expensing. While previous studies explore arguments in support of, or against, ESO expensing from the *perspective of management* by analyzing the firms' decision to voluntarily expense ESO and the consequent market reaction (e.g. Aboody et al., 2004a)—focusing mostly on issues of signaling and transparency—our study provides a unique opportunity to explore those arguments from the *perspective of shareholders* in a context where managers oppose ESO expensing.[3]

Our study also provides first evidence of a mechanism—shareholder voting—that shareholders could apply to affect accounting choices at the firm level and perhaps to affect regulators' decisions at a broader level.[4] In this setting, shareholder votes may have used the voting process to gather and formalize other investors' support, generate media attention, pressure targeted firms and influence the standard-setting process (Watts and Zimmerman 1990). Our study documents the wide support of these votes and the reasons that led shareholders to support the expensing of ESO in the firm's income statements.

[3] In this respect, our study is closer in spirit to Espahbodi et al. (2002), who analyze cross-sectional stock price reactions to FASB deliberations on ESO expensing in the early 1990s, the key difference being that we infer shareholders' preferences from their voting decision rather than from stock price changes. Arguably, shareholders' trading decisions (as reflected in stock price changes) provide a stronger indication of shareholders' preferences relative to the votes cast at the annual meeting. However, shareholders' voting decisions are likely to be a more direct and less noisy measure of their preferences. Besides, while stock price changes (or the lack thereof) reflect the view of the 'marginal' shareholder, the voting outcome reflects the views of all shareholders, thereby giving us the opportunity to explore the preferences of different types of shareholders.

The remainder of the paper is organized as follows. In Section 2 we develop our hypotheses on the determinants of votes in favor and against ESO expensing. Section 3 describes the sample and the voting outcome, and analyzes the characteristics of the targeted firms. After outlining our methodology and defining the variables used in the tests (Section 4), in Section 5 we present the results of the analysis of the determinants of the voting outcome. Section 6 concludes.

2. Literature Review and Hypotheses Development

The increase in the level of CEO compensation during the 1990s, mostly fueled by large grants of ESO, has attracted strong criticism from investors, concerned with a possible disconnect between CEO pay and firms' performance[5], increasing dilution levels (also due to the widespread use of ESO at the non-executive level), and distorted incentives potentially provided by excessive option grants. Indeed, a number of studies document a positive association between option compensation and earnings management (Bergstresser and Philippon 2005), accounting restatements (Burns and Kedia 2006; Efendi et al. 2007), and shareholder litigation (Peng and Roell 2004). Research has also documented opportunistic behavior in the timing of CEO option grants and repricings (Yermack 1997; Ferri 2005; Heron and Lie 2007), as well as in terms of disclosures and/or earnings management around option grants and option exercises (Aboody and Kasznik 2000; Balsam et al. 2003; Bartov and Mohanram 2004).

There is a general belief among the public that the explosive growth in the use of ESO was partly the result of lack of mandatory ESO expensing because "*when something is significantly under-priced, it is often also substantially over-consumed*" (Standard & Poor 2002). A corollary

[4] FASB's recent decision to re-examine the accounting rules for pension plans may well create another opportunity for shareholder proposals to be a powerful lobbying mechanism.

of this argument is that expensing ESO would lead to a reduction in their use.[6] In particular, voting shareholders may have expected that voting in favor of ESO expensing would result in lower use of options in CEO compensation for three main reasons. First, managers and Boards may have been concerned with the higher visibility and scrutiny of CEO compensation triggered by a recognition regime (Guay et al. 2003).[7] Second, a positive voting outcome (whether or not resulting in ESO expensing) and the resulting media coverage may have also resulted in higher visibility of CEO compensation and put pressure on Compensation Committees to restructure the compensation packages (Thomas and Martin, 1999). Finally, if managers and directors fixated on earnings—because of concerns with the effect on bonuses and/or because they believe markets are fixated on earnings—they may have been expected to reduce ESO awards in an attempt to minimize the impact on earnings. The above arguments lead to the following hypothesis:

Hypothesis 1 (H1): Ceteris paribus, the fraction of votes in favor of ESO expensing is greater in firms characterized by perceived excessive CEO option compensation.

Some voting shareholders, however, may have feared that ESO expensing would cause a drop in stock price proportional to the magnitude of the expense, for two reasons.

First, ESO expensing could reveal to the market the extent of the option compensation cost—the underlying assumption being that investors would not have been able to fully recognize this

[5] The extent to which CEO pay actually reflects performance is currently a subject of intense debate in the academic community. See Bebchuk and Fried (2004) and Core et al. (2004) for two opposing views and thorough discussions of the empirical evidence to date.

[6] Brown and Lee (2007) document a significant reduction in the use of ESO in total compensation for top 5 executives as a result of mandatory ESO expensing (FAS123R) and show that such reduction resulted in a decrease in total compensation in firms with abnormally high executive compensation before FAS 123R.

[7] Previous studies suggest that firms whose executives receive higher compensation are more likely to: (i) lobby against more explicit forms of disclosure of their compensation (Dechow et al. 1996; Hill et al. 2002), (ii) disavow (Blacconiere et al. 2004) and manage downward the option expense disclosed (Aboody et al. 2006) or recognized (Johnston 2006) under SFAS 123, and (iii) have poorer voluntary disclosure of compensation practices in the proxy statements (Laksmana 2005).

amount from the financial footnotes, either because they were fixated on the earnings number or because information disclosed in footnotes was less reliable/visible (Bodie et al. 2003; Libby et al. 2005) and more costly to process (Barth et al. 2003) than information recognized in the income statement. While a number of papers documented that the SFAS 123 footnote (pro forma) disclosures were value relevant (Aboody 1996a; Aboody et al. 2004b), these findings do not imply that ESOs were fully and correctly priced before the SFAS 123R rule was approved, Indeed, Espahbodi et al. (2002) analyzed returns around FASB announcements during its deliberations of SFAS 123 and concluded that the disclosure of ESO expense was not a substitute for its recognition. It follows that, to the extent that investors placed more weight on recognized versus disclosed amounts (e.g. Aboody 1996b), recognizing the ESO expense could have triggered a price decline proportional to its magnitude.

A second argument is that ESO expensing could create real economic costs to the firm if it affected the terms of the firm's contracts or required their renegotiation (Watts and Zimmerman 1990; Guay et al. 2003).

Under either argument ESO expensing may have led investors to expect a negative price reaction proportional to the magnitude of the expense, resulting in the following hypothesis:

Hypothesis 2 (H2): Ceteris paribus, the fraction of votes in favor of ESO expensing is lower in firms characterized by greater expected earnings impact from expensing options.

Our next hypotheses refer to the impact of ownership composition on the voting outcome. Historically, institutions have mostly voted in concert with management, but recent evidence documents a positive association between institutional ownership and votes in support of governance-related shareholder proposals (Bethel and Gillan 2003). With respect to ESO expensing, while numerous surveys indicated that the vast majority of institutional investors

were in favor (CalPERS 2002; McKinsey & Co. 2002), theoretical arguments lead to different predictions for different types of institutional investors, depending on their investment horizons and strategies (Bushee 1998), as well as potential conflicts of interest (Black 1990; Almazan et al. 2005). As a result, we make no prediction on the sign of the overall relation between institutional ownership and voting outcome.

However, we hypothesize that institutional investors more concerned with *short-term reported earnings*—and thus, with the negative earnings impact from expensing ESO[8]—would have been more likely to vote against the proposal, while institutions more concerned with *long-term value*—and, thus, with the benefits from a reduction in excessive option usage—would have bee n more likely to vote in favor:

Hypothesis 3a (H3a): Ceteris paribus, the fraction of votes in favor of ESO expensing is higher (lower) in firms characterized by higher fraction of votes controlled by 'long-term value' ('short-term earnings') oriented institutional investors.

Also, we hypothesize that institutions more likely to have business dealings with the firm, such as banks or insurance companies, would have been more likely to vote with management (e.g. Brickley et al. 1988) and, thus, against the proposal, while institutions with lower or no conflicts of interests, such as public pension funds, would have been more likely to vote in favor of ESO expensing in an attempt to discipline the use of option-based compensation (Almazan et al. 2005):

[8] Bushee (2001) finds that institutions with short investment horizons myopically price firms, overweighting short-term earnings potential and underweighting long-term earnings potential. Other studies document that firms with high level of transient ownership are more likely to meet or beat expectations on a consistent basis (Matsumoto 2002) and to reduce their CEOs compensation in case of negative earnings surprises (Shin 2005).

Hypothesis 3b (H3b): Ceteris paribus, the fraction of votes in favor of ESO expensing is lower (higher) in firms characterized by higher fraction of votes controlled by institutional investors with greater (smaller) potential conflicts of interest.

By definition, Boards and management of our sample firms strongly opposed shareholder proposals for ESO expensing (see Appendix 2)—if this was not the case, the proposals would not have been put for a vote in the first place. Thus, in line with findings in previous studies on shareholder proposals (Gordon and Pound 1993; Bethel and Gillan 2003), we expect a strong negative relation between insider-controlled votes and votes in favor of expensing.

Hypothesis 4a (H4a): Ceteris paribus, the fraction of votes in favor of ESO expensing is lower in firms characterized by higher fraction of votes controlled by insiders.

A more interesting question is whether the level of insiders' ownership affected *non-insiders'* votes. In this respect, we predict that non-insider shareholders may have believed that higher insider ownership would exacerbate the problems associated with excessive option compensation:

Hypothesis 4b (H4b): Ceteris paribus, the fraction of non-insider votes in favor of ESO expensing is higher in firms characterized by higher insiders' ownership.

3. Sample Selection and Description of the Voting Outcome

In this section we provide a description of our data (Section 3.1) and the voting outcome of the ESO proposal (Section 3.2). We also explore the incentives of the proponents and provide an analysis of the characteristics of the targeted firms (Section 3.3).

3.1 Sample and Data Sources

Our sample consists of all ESO-expensing shareholder proposals submitted during the 2003 and 2004 proxy seasons, which correspond to the time between the SEC's decision to allow ESO

expensing shareholder proposals (December 2002) and the FASB's release of rule SFAS No.123R mandating the fair value method of accounting for ESO (December 2004). To identify these proposals, we perform a keyword search in the proxy statements of all firms registered at the SEC including the words "Proposal" and "Expensing" within a distance of six words. We complement this search with a list of proposals submitted and then withdrawn (and, thus, never included in the proxy statements) provided by the United Brotherhood of Carpenters and Joiners of America (UBCJA) and with other online references (The Corporate Library, Georgeson Shareholder). Our search yielded 153 shareholder proposals (in 131 firms), 107 of which were voted upon at the annual meeting (Table 1, Panel A).

In order to analyze the determinants of the voting outcome and the reasons why firms were targeted in the first place, we collect data from eight sources. The first source is the proxy statement prior to and the 10Q report following the annual meeting. From this source we hand-collect information about the ESO expensing proposals as well as any other compensation-related proposals (voting outcome, voting turnout, identity of proponents, date of annual meeting, etc.), as well as some insider ownership and governance data. We obtain additional data from seven other sources: CRSP (stock price returns), Compustat (financial data and industry classification), ExecuComp (compensation and governance variables), Thompson Financial (institutional ownership), Securities Data Corporation (capital market activity), 10-Ks and the Bureau of Labor Statistics (degree of unionization at firm and industry level), and the December 16, 2004 Equity Research Report by Bear Stearns (list of firms voluntarily expensing ESO).

3.2 Significance of the Voting Outcome

Under the current legal regime, shareholder proposals are typically non-binding, raising the question of the significance of the shareholders' vote. Several characteristics of the ESO

proposal suggest the vote on this issue was well informed and was significant both to the managers and to the shareholders of the targeted firms.

Evidence suggests *managers* reacted to the proposal both before and after the vote. We found that about 25% of the firms targeted in 2003 agreed to expense before the annual meeting (thus, avoiding the vote before it occurred). Some of the other firms tried to exclude the proposal from the proxy, or engaged in costly campaigns to promote a vote against the proposal.[9] These efforts suggest that managers were concerned with the consequences of an undesired voting outcome. Managers also reacted to the proposal after the vote. Ferri and Sandino (2007) show that the degree of voting support for the ESO proposal was associated with (i) a higher likelihood of subsequently adopting ESO expensing, (ii) a decrease in the level of CEO compensation, and (iii) a decrease in the use of ESO in CEO compensation.

The vote was also significant to the *shareholders*. Shareholders had several reasons to believe they could and/or should influence the voting outcome. First, the pro-expensing position of some of the institutional investors and their influential representatives (e.g. TIAA-CREF, Council for Institutional Investors, Institutional Shareholder Services) was well known *before* the proxy season, Second, the voting outcome of the first proposals confirmed that there was a real chance to obtain a majority vote, creating a domino effect on subsequent proposals. Finally, there was significant potential for positive spillover effects, for two reasons: (i) the high press coverage put pressure on and elicit a reaction from management and Boards even in non-targeted firms (Ferri and Sandino 2007); (ii) a majority vote could have affected FASB decision to

[9] For example, Intel's CEO and Chairman launched a massive campaign against the proposal sending numerous letters to the shareholders, setting up a website supporting their position, selecting and recommending articles about the issue, providing a telephone line to answer questions from shareholders, and sending voluminous information to the largest shareholders (Source: www.sec.gov, Proxy Material filed by Intel Corp).

mandate the expensing of ESO for *all* publicly traded firms and thus (all else being equal) increase exponentially any expected benefit (e.g. more disciplined use of options).

The high voting turnout (72.5% on average) and the high degree of support for the proposal, confirmed the engagement of shareholders in the voting process. As shown in the bottom line of Table 1, Panel B, on average, the proposals received 47% votes FOR relative to votes AGAINST and ABSTAINED, resulting in 51 out of 107 proposals being approved – one of the most successful rates of approval for a shareholder proposal (Georgeson Shareholder).[10] Even more tellingly, votes FOR ESO expensing as a percentage of all non-insider votes averaged 56.9% and would have yielded a majority vote at 77 firms. Shareholders' support increased over time, with 62% of the proposals being approved in 2004, compared to 42% in 2003.[11] Interestingly, the % votes FOR increased in 20 of the 22 firms that were targeted both in 2003 and 2004, and resulted in majority votes in almost half of the firms where the proposal had been rejected in 2003, including some high-profile cases among tech firms, such as Hewlett Packard, IBM and Intel. This favorable voting outcome was highly publicized by the press and evoked by shareholders in their lobbying efforts to persuade the FASB to mandate ESO expensing, as exemplified in the epigraph.

[TABLE 1 APPROX. HERE]

3.3 Shareholder Proponents and Characteristics of Targeted Firms

Table 1, Panel B, reveals that most proposals were sponsored by union funds.[12] The peculiar nature of the proponent opens the possibility of a sample selection bias. The unions launched this

[10] In contrast, other compensation-related shareholder proposals submitted to the same firms during the same period averaged less than 20% votes FOR.

[11] The increase in voting support in 2004 may reflect a perception that mandatory ESO expensing was unavoidable after the issuance of FASB Exposure Draft in March 2004. Also, a new S.E.C. rule mandating public disclosure of proxy votes by mutual funds may have resulted in more votes for ESO expensing.

[12] In recent years unions have been increasingly active on a number of governance and compensation issues, such as prohibition of consulting work from auditors, adoption of performance-based options, Board independence criteria,

initiative in the summer of 2002 to induce FASB (and, to a lesser extent, the targeted firms) to reconsider the accounting treatment for ESO whilst generating a debate on the effectiveness of option-based compensation.[13] Both objectives were more likely to be achieved if the proposals received high voting support, if the votes generated significant media attention, and if the sample was regarded as broadly representative of the underlying population.[14] For these reasons, the unions claimed that they chose to target an approximately "random" sample of firms with respect to magnitude of ESO expense, degree of use of ESO, past performance, etc,[15] but with an explicit bias toward *large* and *visible* firms, more likely to obtain stronger press coverage and, thus, capture the attention of the investment community and the standard setters. However, activists' targeting criteria may well be driven by their own political agenda (Business Week 2004). In our setting, targeted firms may have been chosen based on their unionized status or because of current negotiations with management. To account for all these possible selection criteria, we analyze the following characteristics of targeted firms (i) the percentage of unionized employees (UNION); (ii) the amount of options outstanding, DILUTION (or, alternatively, CEO option holdings, OPTCEO) and the magnitude of the option expense (OPTEXPENSE)[16]; (iii) other determinants of the likelihood of being targeted by a shareholder proposal identified in previous

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Board election system, etc. (Georgeson Shareholder). For a general discussion of the dual role of unions as shareholders and employees' representatives, see Schwab and Thomas (1998).

[13] Part of this section is based on an interview with Edward J. Durkin, director of corporate affairs at United Brotherhood of Carpenters and Joiners of America (UBCJA), leader of the group of seven builder-trades unions (UBCJA, LIUNA, IBEW, IBT, CPF, SMWIA, UA – see Table 1, Panel B) that jointly promoted the ESO expensing initiative.

[14] Note that these three elements may be in conflict with each other. For example, a sample of firms where voting support may be expected to be high (e.g. firms with low ESO expense, poor performance and/or questionable compensation practices) may have little impact on FASB because it would not represent the views of the investment community at large. Similarly, a high voting support at firms with low use of options would likely not attract significant media coverage.

[15] *"We aren't singling out any companies in particular…We are targeting a broad range of companies. So at the end of the (proxy) season, we can take to FASB and the business community votes by shareholders saying it's time to expense options"* (Pensions & Investments 2003).

studies (Karpoff et al. 1996; Johnson and Shackell 1997; Bizjak and Marquette 1998), namely executives' ownership (EXECOWN), institutional ownership (INSTOWN), total assets (LNSIZE), market-to-book ratio (MB_RATIO), three-year stock returns (RETURNS), debt ratio (LEVERAGE), the percentage of executives sitting on the Board (EXECONBOARD) and a dummy for high-tech firms (HITECH).

The 153 firms targeted were indeed distributed across multiple industries, though the industry composition differs from that of all Compustat firms (see chi-square test in Table 2, Panel A), due to an over-representation of firms in the utility sector. Table 2, Panel B (left section) compares the targeted firms to the population in terms of the variables described above. While there are many significant differences, the most striking one is that targeted firms are about five times larger in total assets ($27.1bn versus $5.3bn). Given the proponents' focus on large, highly visible firms and since 95% of the targeted firms either are in the S&P 500 or are larger in size than the smallest firm in the S&P 500, in the right section of Panel B, we also compare targeted firms to other firms in the S&P 500 index (excluding those already expensing ESO). Univariate tests suggest that firms targeted by the ESO expensing proposals are still significantly larger, tend to have somewhat lower levels of institutional ownership and options expense (though these differences do not appear economically relevant), but do not differ significantly in terms of growth opportunities, leverage, dilution and governance characteristics. Noticeably, they have a higher percentage of unionized employees, but the difference is not statistically significant. Similar results hold for the sub-sample of 107 targeted firms where the proposal was ultimately voted upon.

[TABLE 2 APPROX. HERE]

[16] We use OPTCEO as alternative to DILUTION both because activists' may especially focus on CEO option holdings and because the correlation between OPTCEO and OPTEXPENSE is only 0.24, versus a correlation of

In a multivariate setting, the probit regression in Table 2, Panel C (col. 1 and 2), shows that, relative to the other firms in the S&P 500, targeted firms tend to be larger, high-tech firms, with higher dilution or CEO option holdings, lower option expense (only in column 1), higher executives' ownership and lower fraction of executives sitting on the Board[17]. Again, the fraction of unionized employees does not appear to be a significant selection criterion. The same analysis for the sub-sample of targeted firms where the proposal was eventually voted upon (columns 3 and 4) yields similar findings, except that size is no longer significant—suggesting that the firms that avoided the vote by agreeing to expense ESO (see Table 1, Panel A) are the largest among the targeted firms. The results in Table 2, Panel C, are substantially unchanged when we re-run the probit regressions clustering by firm to account for cases with proposals in both 2003 and 2004, except that OPTEXPENSE is always statistically significant with a p-value below 0.05..

4. Research Design and Variable Definitions

To test our hypotheses we use the following OLS regression:

% Votes FOR ESO Expensing = f (Excessive Option Compensation, Expected Earnings Impact from ESO Expensing, % Votes controlled by Institutions, % Votes controlled by Insiders, Control Variables) (1)

To account for selection bias, we also employ a two-step Heckman model where the first step (probability of the ESO expensing proposal being voted upon) is the probit model described in Sec.3.3 (see Table 2, Panel C, col.3[18]) and the second step is the OLS regression in (1), with the

0.51 between DILUTION and OPTEXPENSE.

[17] More independent Boards may be targeted because more likely to adopt the proposal either before the vote or after a majority-vote (Ertimur et al. 2005). Also, outside Board members are likely to sit on Boards in other firms, creating the opportunity for spillover effects.

[18] The results in the rest of the paper are unchanged when the inverse Mill's ratio is obtained instead from the probit regression in Table 2, panel C, column 4.

inverse Mill's ratio (LAMBDA) obtained from the first-step probit regression included among the control variables.

Dependent Variable: % Votes FOR ESO Expensing

Our dependent variable is the percentage of votes FOR, computed as:

VOTESFOR= # Votes For / (# Votes For + # Votes Against)

Since our dependent variable is a percentage, consistent with previous literature on shareholder voting (e.g. Bethel and Gillan 2003), in the regressions we use its logit transformation: *VOTES = Log (VOTESFOR / (1 - VOTESFOR))*.[19]

Main Independent Variables

Below we describe the variables used to test our hypotheses. Appendix 3 provides more details on their computation and the data sources used.

a) Excessive CEO Option Compensation

Excessive CEO Option Compensation [*EXCESSOPTCEO*]: critics of ESO generally point to the "mega-grants" of options to top management—in particular the CEO—and to the resulting high levels of dilution (Thomas and Martin 2000). Accordingly, our proxy for excessive option compensation (EXCESSOPTCEO) focuses on CEO's option holdings and is computed as the difference in the ratio (Number of Options held by CEO/Total Shares Outstanding) between each sample firm and an 'industry-size' median, scaled by the 'industry-size' median. The 'industry-size' median is the median value of the above ratio for a control group of firms of similar size, in the same industry (see Appendix 3 for details). Thus, we assume that shareholders, following the practice of most compensation consultants (Bizjak et al. 2000), will assess their firm's option granting practices relative to a set of peer companies.

[19] All the results presented in this study are unchanged when we use *VOTESFOR* instead of *VOTES*, as well as when *VOTESFOR* is redefined as percentage of *all* votes cast, *including* abstention votes.

b) Expected Earnings Impact from ESO Expensing

We examine two measures of the earnings impact from recognizing the ESO expense:

- *Magnitude of Option Expense* [*OPTEXPENSE*]: a natural proxy for shareholders' concern about negative consequences from ESO expensing is the magnitude of the disclosed option expense, scaled by the market value of equity.
- *Profit Loss Threshold* [*PROFTHRESH*]: voting shareholders may be concerned with the effect of expensing on certain earnings benchmarks. In particular, they may fear that a change from profit to loss will affect price. Previous literature has documented negative liquidity effects associated with reporting losses (Hwang et al. 1996; Ertimur 2003). Hence, we construct a *profit/loss threshold* dummy equal to 1 if recognizing the ESO expense would have turned a profit into a loss, and 0 otherwise.

c) Ownership Composition

To understand the voting behavior of institutional investors we first look at an aggregate proxy measure of the fraction of votes controlled by institutions:

- *% Votes Controlled by Institutions* [*INSTOWN*]: % of shares held by institutional investors.

Then, to capture the characteristics of different types of institutional investors and test, respectively, H3a and H3b, we decompose institutional ownership (INSTOWN) in two ways:

- *% Votes Controlled by 'Long-term'* [*LONGTERM*] *and 'Transient'* [*TRANSIENT*] *Institutional Investors*: Bushee (1998) classifies institutions based on their past investment behavior, measured in terms of portfolio turnover, diversification and trading sensitivity to current earnings news. "Transient" institutions have the highest turnover and follow momentum investment strategies, "Dedicated" institutions are characterized by having large investments in firms, low portfolio turnover, and no trading sensitivity to current earnings

news, while "Quasi-indexers" are characterized by high diversification and low portfolio turnover—a characteristic of buy-and-hold value strategies. We group "Dedicated" and "Quasi-indexers" institutions into LONGTERM institutions and predict higher votes FOR from these institutions and higher votes AGAINST by TRANSIENT institutions.

- *% Votes Controlled by 'Active'* [*ACTIVE*] *and 'Passive'* [*PASSIVE*] *Institutional Investors*: Following numerous studies in finance (e.g. Brickley et al. 1988), we classify banks and insurance companies as PASSIVE institutions (i.e. with high potential conflicts of interest), while investment companies, independent investment advisors, and other institutional investors are classified as ACTIVE institutions (i.e. with low conflicts of interest).

To test H4, we compute the *percentage of votes controlled by insiders* [*INSIDEOWN*].

Control Variables

We examine three sets of control variables, capturing, respectively, the *financial characteristics* of the firms, certain *corporate governance* features, and *industry* effects.

a) Controls related to Financial Characteristics

- *Size* [*SIZE*]: Although shareholder proposals typically receive lower support in larger firms,[20] several arguments lead us to predict the opposite relation in our setting. Larger firms have a stronger motivation to commit to transparent reporting due to their higher visibility (Watts and Zimmerman 1990; Aboody et al. 2004a) and should be less concerned about a negative price effect from expensing ESO because of higher coverage by capital market intermediaries (i.e. price is more likely to already impound information in financial footnotes reported under SFAS 123). Smaller firms, on the other hand, may be more concerned about an excessive

[20] Gordon and Pound (1993) and Bethel and Gillan (2003) note that in larger firms executives have greater political power and are able to spend more resources lobbying against shareholder proposals (e.g. investing in public relations and proxy solicitors). Bizjak and Marquette (1998) also highlight that larger firms have a more diverse shareholder base, increasing the costs of collective action.

reduction in option compensation since it is more costly for them to replace options with other incentives due to cash constraints. Thus, we expect a positive relation between firms' size and votes in favor of expensing.

- *Past Performance* [*ADJRET*]*:* shareholder proposals tend to receive greater support in firms with poor past performance (e.g. Gillan and Starks 2000). Thus, we predict a negative relation between stock performance and votes in favor of expensing.
- *Leverage [LEVERAGE]:* evidence in prior studies suggests that violation of debt covenants is costly and that firms select accounting methods to minimize the likelihood of such violations (DeFond and Jiambalvo 1994; Sweeney 1994). Since ESO expense recognition results in lower debt-equity ratios[21], we predict that firms with higher leverage will be more likely to vote in favor of ESO expensing.[22]
- *Interest Coverage [INTERESTCOVG]:* while recognition of ESO expense reduces reported leverage, it also has the effect of reducing the interest coverage ratio, and, thus, raises the likelihood of violating certain debt covenants. We address this possibility by controlling explicitly for the interest coverage ratio.

b) Controls related to Corporate Governance Features

Arguably, the extent to which shareholders will rely on ESO expensing as a means to curb excessive option compensation should depend on the effectiveness of alternative compensation-related governance mechanisms.[23] Accordingly, we construct the following three variables:

[21]To recognize option expense, firms debit expense for the amount of the expense, debit deferred taxes for the tax effect of the expense, and credit an equity account for the sum. The net effect is to increase equity by the amount of deferred taxes, thereby resulting in lower debt-equity ratio.

[22] This prediction is consistent with Aboody et al. (2004a), who find that firms with higher debt-equity ratios are more likely to voluntarily expense ESO.

[23] In theory, shareholders may affect compensation policies indirectly through their representatives (the Compensation Committee of the Board of Directors), or directly by voting against stock option plans, presenting compensation-related proposals at the annual meeting and filing lawsuits over compensation matters. Bebchuk and Fried (2004) review the evidence on the effectiveness of these mechanisms and discuss their limitations.

- *Conflict of Interest on the Compensation Committee [CONFLICT]:* we define a dummy variable equal to 1 if the firm discloses any conflict of interest on the Compensation Committee. We assume that in these firms the Compensation Committee will be less effective in curbing excessive option compensation and, thus, we expect their shareholders to be more likely to vote in favor of ESO expensing.
- *Votes withheld from Directors [VOTESWITHHELD]:* In recent years, shareholders have expressed their dissatisfaction with the effectiveness of Boards of Directors by withholding votes from one or more directors standing up for re-election at the annual meeting. These so-called 'no-vote' campaigns are typically directed at all members of the Board, though sometimes they may target individual members or members of a specific committee, such as the Compensation Committee (Del Guercio et al. 2004). We calculate the highest percentage of votes withheld from any director up for re-election at the annual meeting where the ESO expensing proposal is voted upon and predict a positive relation between this variable and votes in favor of ESO expensing.
- *Equity-based Compensation Plans Adopted Without Shareholder Approval [NONAPPROVEQUITY]*: recent SEC rules require firms to obtain shareholder approval for, and disclose, all their equity compensation plans (SEC 2002, 2003). We calculate the fraction of outstanding options which was granted under equity compensation plans not submitted to shareholders for approval. Prior studies suggest that this measure is a symptom of poor governance (Weber et al. 2003). Thus, we expect a positive relation with votes FOR.

c) Controls related to Industry Effects

- *Fraction of Voluntary Option Expensers in Same Industry* [*VOLUNTEXP*]: by the end of 2004, more than 800 firms had started to voluntarily recognize ESO expense. A common

argument against ESO expensing is that it would put the firm at a competitive disadvantage relative to its peers (Appendix 2). This argument would lead to predict a positive relation between VOLUNTEXP and voting support for ESO expensing. However, Aboody et al. (2004a) document a positive market reaction at announcements of ESO expensing decisions only for 'early adopters,' consistent with a first-mover advantage in signaling their commitment to increased financial transparency. Hence, a high fraction of voluntary expensers in the same industry may reduce or eliminate this advantage, resulting in no relation between VOLUNTEXP and votes in favor of ESO expensing.

- *Dummy for high-tech industry* [*HITECH*]: due to the tight labor market characterizing the high-tech industry and the cash scarcity affecting entrepreneurial high-tech firms, shareholders in these firms may be concerned that an excessive reduction in option-based compensation will affect the firm's ability to attract and retain the best employees. Indeed, Espahbodi et al. (2002) document more pronounced abnormal returns for high-tech companies—after controlling for options' usage—during FASB's deliberations leading to the issuance of SFAS 123 in 1995. Thus, we predict lower votes FOR in high-tech firms.

5. Empirical Analysis and Results

5.1 Descriptive Statistics and Correlations

Table 3 (Panel A) reports descriptive statistics for the variables of interest. The percentage of votes for expensing (VOTESFOR) ranges between 9 and 80%, with a mean of 49%. Our measure for excessive option compensation, EXCESSOPTCEO, shows significant variation and results in about 48% of the firms classified as having excessive CEO option compensation. The ratio of option expense to market value of equity (OPTEXPENSE) has a mean (median) of 1.1%

(0.4%), which is larger than the corresponding figure in the sample of voluntary option expensers analyzed by Aboody et al. (2004a)—0.6% (0.2%)—suggesting higher option usage in firms targeted by ESO expensing proposals than in voluntary expensers. For about 7.5% of the sample firms, expensing ESO would have turned a profit into a loss (PROFTHRESH). Mean institutional (insiders') ownership is 65% (10%). The mean (median) firm in our sample has about $23.1bn ($8.6bn) in total assets and a debt-to-assets ratio of 23.8%, though there is significant variation along both characteristics. The three-year industry-adjusted stock returns (ADJRET) are negative for about two-thirds of the sample, with a mean of -21.3%. Almost 20% of the sample firms disclose a conflict of interest on their Compensation Committee (CONFLICT), while over 55% reported the existence of non-approved equity-based compensation plans (covering on average, 23% of the options outstanding). On average, the highest percentage of votes withheld from a director up for re-election is 11.7%. High-tech firms comprise about a quarter of the sample, while the average fraction of same-industry firms voluntarily expensing ESO (VOLUNTEXP) is 4.3% (with 70% of the sample having at least one firm in the same industry voluntarily expensing ESO).

[TABLE 3 APPROX. HERE]

Table 3 (Panel B) reports the Pearson correlations among the variables included in our main tests. Consistent with prior studies on shareholder voting, ownership composition is a key determinant of the voting outcome, with VOTESFOR showing strong positive (negative) correlation with institutional (insiders') ownership. As predicted, VOTESFOR is also significantly and positively correlated with EXCESSOPTCEO and with a number of control variables (SIZE, LEVERAGE, VOTESWITHHELD and NONAPPROVEQUITY), while there

is almost no correlation with our measures of expected earnings impact (OPTEXPENSE and PROFTHRESH).

5.2 Multivariate Analysis

5.2.1 Main Results

To test our hypotheses on the determinants of the voting outcome, we employ the following OLS regression (clustering by firm to account for cases with proposals in both 2003 and 2004):

$$VOTES_i = \beta_0 + \beta_1 * EXCESSOPTCEO_i + \beta_2 * EARNINGSIMPACT + \beta_3 * INSIDEOWN_i + \beta_4 * INSTOWN_i + \beta_n * CONTROLS_i + \varepsilon_i \quad (2)$$

where *EARNINGSIMPACT* is alternatively defined as *OPTEXPENSE* or *PROFTHRESH*.

The results in Table 4 (Panel A, columns 1 and 2) provide significant support for hypotheses 1, 2 and 4a. The coefficient on EXCESSOPTCEO is positive and significant, as predicted by H1, while OPTEXPENSE (or alternatively, PROFTHRESH) and INSIDEOWN have a negative and significant coefficient, consistent with H2 and H4a, respectively. The coefficient on INSTOWN is positive and highly significant, suggesting that, on average, institutional investors vote FOR.

To better interpret the result on the compensation variable, in untabulated tests we introduce another measure of excessive option usage based on all options outstanding *other than* those held by the CEO (EXCESSOPTNONCEO). Taken together, EXCESSOPTCEO and EXCESSOPTNONCEO measure the amount of excessive dilution (i.e. excessive relative to firms of similar size in the same industry). Interestingly, we find that EXCESSOPTNONCEO is not related to the voting outcome. We interpret this finding as an indication that shareholders are not concerned with the cost of granting too many options per se, but with the (more substantial) costs potentially stemming from the distorted incentives that excessive option packages may induce in those with significant decision-making authority—the CEO *in primis*.

To investigate differences across institutional investors (H3a and H3b), we split them first into LONGTERM and TRANSIENT (columns 3 and 4), and then into ACTIVE and PASSIVE (columns 5 and 6). As predicted (H3a), there is a positive and significant association between LONGTERM institutions and votes in favor of expensing, but we do not find that TRANSIENT institutions oppose expensing. On the contrary, the coefficient is positive and significant. Stronger support is found for H3b, in that only ACTIVE institutions are positively and significantly associated with votes in favor of ESO expensing,[24] while the coefficient on PASSIVE is insignificant (though positive).

[TABLE 4 APPROX. HERE]

To provide evidence on how the level of insiders' ownership affects non-insider votes (Hypothesis 4b), we repeat the analysis in columns 1 and 2 after redefining VOTESFOR as a fraction of all votes cast by *non-insiders*, implicitly assuming that all insiders voted against.[25] This assumption is supported by the high correlation between INSIDEOWN and VOTESFOR (Table 3, Panel B) and allows us to focus on the determinants of the votes really "in play". Results are presented in columns 7 and 8. The coefficient on INSIDEOWN is now positive and significant, consistent with our conjecture (H4b) that non-insiders are more concerned with excessive option compensation and, thus, more likely to vote for ESO expensing, when insiders' ownership is higher. In spite of the significant drop in R-square, the other results are unchanged,

[24] Note that the ACTIVE category includes groups – such as mutual funds – who may indeed be subject to significant conflicts of interest when casting their votes. This problem has prompted the S.E.C. to require mutual funds to disclose their proxy votes (starting with the proxy season 2004). Davis and Kim (2005) analyze the voting records of 23 fund families in the 2004 proxy season over a number of shareholder proposals, including ESO expensing. Overall, they do not find evidence that mutual funds vote with management at their clients, but they find a positive relation between propensity to vote with management and volume of pension business, both in general and for the ESO expensing proposal in particular. They also document that CalPERS abstained from voting on ESO expensing proposals in 2004, possibly to 'please' the high-tech business community in California – an indication of more complex conflicts of interest than the ACTIVE/PASSIVE classification may suggest.

[25] The dependent variable is therefore *NONINSIDER_VOTES*= log [*NONINSVOTESFOR/(1-NONINSVOTESFOR*)], where *NONINSVOTESFOR*= Votes For /(Votes For + Votes Against – Votes Insiders).

thereby strengthening our confidence in the results. In untabulated tests, we also repeat the analyses in columns 3-6 after re-defining VOTESFOR as a fraction of all votes cast by non-insiders. Again, the coefficient on INSIDEOWN is positive and significant, and the previous inferences about the relation between voting outcome and types of institutional ownership are essentially unaffected.

Results for the control variables are generally consistent across the eight columns. Most of the controls related to "financial characteristics" are significant in the predicted direction: ESO expensing proposals tend to receive greater support in firms with higher leverage, higher interest coverage ratio (though only in some specifications) and worse stock performance, while the coefficient on size, though positive, is not significant. As predicted, the voting outcome is positively correlated with VOTESWITHHELD, suggesting greater support for ESO expensing when alternative monitoring mechanisms (Board of Directors) are believed to be ineffective. The other controls related to "governance" and "industry" characteristics are not significant.

5.2.2 Robustness Tests

To verify the robustness of our results we performed a series of additional tests.

First, we find that in all the OLS regressions above, the independent variables have a Variance Inflation Factor (VIF) score below 3, alleviating concerns of multi-collinearity.

Second, to account for potential selection bias, in Table 4 Panel B, we repeat the analysis using a two-step Heckman procedure and find that the results in Panel A are basically unchanged, except that VOTESWITHHELD, though still positive, becomes often insignificant and that VOLUNTEXP is significantly negative in columns 7 and 8. Noticeably, the coefficient on LAMBDA (the inverse Mill's ratio obtained from the first-step probit regression) is not significant, suggesting that selection bias is not a concern.

Finally, we performed some robustness tests on the main variables. In particular, we redefined OPTEXPENSE based on the three-year average option expense as opposed to the option expense disclosed in the last fiscal year. Also, we re-computed EXCESSOPTCEO i) to account for differences in CEO tenure[26], and ii) to include options held by all the Named Executive Officers (i.e. top 5 executives) as opposed to the CEO only. The results in Table 4 are largely robust to these alternative definitions, with two exceptions: PASSIVE becomes mostly significant under the alternative definitions of EXCESSOPTCEO, and OPTEXPENSE becomes insignificant in Panel B when we redefine EXCESSOPTCEO to account for differences in CEO tenure.

6. Conclusions

Over the 2003 and 2004 proxy seasons, a group of union funds and other shareholder activists targeted more than 150 firms with a proposal to expense ESO—the first time, the S.E.C. allowed shareholder proposals on an accounting matter. In this study we provide evidence on shareholders' views on ESO expensing by examining the voting outcome of these proposals at a sample of 107 firms.

We document that voting support was among the largest for a shareholder proposal (on average, 47% votes for). We find votes in favor of ESO expensing were higher in firms with more perceived excessive CEO option compensation and lower expected earnings impact from expensing, consistent with the notion that shareholders traded-off the potential costs associated with the earnings impact for the benefits of a more moderate use of ESO (expected as a result of

[26] Ceteris paribus, a newly appointed CEO (particularly if not a former executive of the firm) will hold less options than her colleagues with longer tenure. Thus, we re-computed EXCESSOPTCEO after dividing the options held by the CEO by the lesser between 5 and the length of CEO tenure. We use 5 years as upper bound because ESO granted

expensing). We also find that shareholder ownership mattered. On average, institutional investors voted in favor of ESO expensing, but they did not do so if they had greater potential conflicts of interest with management. Not surprisingly insiders sided with management and voted against ESO expensing, but interestingly, insider ownership was positively related to votes cast in favor of ESO expensing by *non-insider* shareholders, possibly due to the perception that higher insider ownership exacerbated the problems associated with excessive option compensation. Finally, support for ESO expensing appeared to be related to a number of control variables, suggesting that like in other shareholder proposals, past performance, contracting costs, and governance concerns played a significant role in shareholders' voting decisions.

In addition to providing evidence on shareholder views on ESO expensing—one of the most controversial issues in accounting history–our work contributes to analyzing a novel lobbying mechanism—shareholder votes—that may be used by shareholders to gather and formalize other investors' support, have a voice and influence on the firms' accounting choices, generate media attention, and, perhaps influence regulators opinions. Our findings may be of interest to managers, shareholder activists, proxy voting services, regulators and standard setters, although we suggest caution in drawing any standard setting implication from our study.[27]

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earlier than 5 years ago are unlikely to be still outstanding, since most ESO vest within 3-4 years and tend to be exercised soon after vesting.

[27] First, we examine a *small* sample of firms – although voting shareholders at these firms constitute a *large*, representative sample of institutional and individual investors. Second, shareholders in these firms are not called to vote on the desirability of ESO expensing for *all* publicly traded firms, thus issues of competitive disadvantage and comparability may play a role - although shareholders were certainly aware that their votes would be watched closely by the business community. Finally, our sample is biased toward large firms. Thus, while we try to correct for selection bias, our results may not be generalizable to smaller firms.

Appendix 1: The 'Path' Toward Option Expensing

Aug 2001	IASB calls for comment on a discussion paper advocating ESO expensing.
Feb 13, 2002	Four Senators present a tax bill that would prohibit companies from deducting the cost of ESO from taxable income unless recognized as an expense in the financials.
May 14, 2002	In Standard & Poor's new Core Earnings measure, ESO are treated as an expense.
Jul 14, 2002	Coca Cola announces that it would begin expensing ESO
Jul 24, 2002	TIAA-CREF lobbies the chairmen of over 1,750 public companies to begin expensing ESO. The Council of Institutional Investors adopts a similar initiative.
Sept 2002	The Conference Board (except Intel's Chairman) endorses ESO expensing.
Sept 2002	Former SEC Chairman H. Pitt states that shareholders should be given the opportunity to vote on whether or not to treat ESO as an expense.
Nov 18, 2002	FASB releases an invitation to comment on the IASB Exposure Draft on accounting for share-based payment (released on November 7, 2002).
Dec 6, 2002	The SEC, reversing its prior position, allows shareholder proposals for ESO expensing to be voted upon at annual meetings.
Feb 2003	E&Y states its support for ESO expensing followed in April by PWC & Grant Thornton
Mar 12, 2003	FASB adds accounting for stock-based compensation to its agenda
Mar 20, 2003	A bill (H.R. 1372) introduced in Congress calling for enhanced disclosure of stock option plans would impose a three-year moratorium on any new related FASB rule.
Apr 22, 2003	FASB deliberates that ESO should be recognized as an expense at fair value.
Jun 2003	By these date, 69 proposals for option expensing—supported by the Institutional Shareholder Services—have been voted upon, with 30 receiving a majority vote.
Oct 29, 2003	FASB deliberates that ESO expensing would be effective starting in 2005 and would apply also to unvested options.
Nov 19, 2003	Senator Enzi (R-Wyo.) introduces a bill which would limit expensing to options granted to a firm's five highest-paid executives and would allow newly public firms to avoid expensing ESO for three years.
Nov 21, 2003	Senator Baker (R-La) introduces a bill (H.R. 3574) which would: i) require the S.E.C. to complete a study before FASB is permitted to implement its proposed rule; ii) limit expensing to options granted to the top 5 five executives (using a zero volatility assumption in the option pricing model), iii) entirely exempt small businesses, and iv) allow newly public firms not to expense ESO for 3 years.
Dec 2003	The anti-expensing lobby argues that expensing will damage productivity and employment at U.S. high-tech firms (Business Week, 12/22/2003).
Jan 2004	Mandatory ESO expensing becomes effective in Canada.
Feb 19, 2004	IASB issues a new standard mandating the expensing of ESO (IFRS 2).
Mar 31, 2004	FASB issues an Exposure Draft requiring the expensing of ESO at grant date.
Jun 30, 2004	Comment period on FASB Exposure Draft is over. More than 7,000 comments letters were received (1,800 from Cisco employees)
Jul 21, 2004	The bill introduced in November 2003 (H.R. 3574) is passed by the House of Representatives, but members of the Senate pledge support for FASB's independence.
Sept 14, 2004	Cisco, Genentech and Qualcomm submit to FASB an option valuation method that would significantly reduce the impact of ESO expensing on earnings.
Oct 2004	FASB delays effective date of new statement to June 15, 2005, under pressure from firms already burdened by Sarbanes-Oxley deadlines.
Nov 30, 2004	A European Union (EU) advisory panel delays vote on adopting the IASB rule on ESO expensing, out of concern with FASB's decision to delay.
Dec 15, 2004	FASB releases SFAS 123R, mandating the expensing of ESO at grant date. Few days later, the EU advisory panel approves the IASB rule on ESO expensing. By this date, approx. 800 U.S. firms have voluntarily adopted ESO expensing.

Appendix 2
Arguments Against and In Favor Of Expensing Stock Options

ARGUMENTS FOR	ARGUMENTS AGAINST
Enhance transparency by reporting accurately the company's operational earnings, including executive compensation costs. A recent report issued by Standard & Poor's indicated that expensing stock options would have lowered operating earnings at companies by as much as ten percent.	**All the cost is reflected in diluted EPS, expensing would be misleading.** The economic cost of a stock option grant is borne by the stockholders through the potential dilution of their ownership interest. To create an expense in addition to the cost of dilution currently reflected in financial statements would impair the transparency, comparability and usefulness of the company's financial reports and would inappropriately and imprecisely "double count" the effect of stock options."
	There is already complete information to assess the impact of stock options on the value of the company. The impact of the potential expense is clearly disclosed in the notes to the Company's Financial Statements according to GAAP rules. A recent study by Towers Perrin, found that announcement of voluntary option expensing had no effect on a company's share price.
	The Black and Scholes model used to estimate the value of employee stock options is inappropriate. The Black-Scholes model was developed to estimate the value of marketable options with relatively short exercise periods. Attributes specific to employee stock options (such as multi-year vesting and non-transferability) are not incorporated in the model.
	The company provides voluntary disclosures to help investors fully understand the nature and impact of the stock option programs
Deter excessive use of options for compensation	**The company has always made a moderate use of options**
	Compensation abuse should be stopped by other corporate governance mechanisms. Stock option abuses are not an accounting issue but a corporate governance issue. Abuse should be addressed by holding directors accountable for their decisions on executive compensation.
Other companies are expensing Recently many companies (including such prominent ones as Coca Cola, Washington Post, and General Electric) have decided to expense stock options in order to provide their shareholders with more accurate financial statements.	**The company should await development of rules by FASB/SEC** The Financial Accounting Standards Board is studying the issue of expensing employee stock options and the debate may be settled in the relatively near future. The Board of Directors believes that it would not be appropriate to begin expensing stock options until there is more clarity on the issue.
	The "Intrinsic Value" Method is the most widely used and investors have a need for financial statements that facilitate comparisons between companies. The firm should follow the most widely used industry practice and should avoid adopting a practice that would place it at a competitive disadvantage.
Deter strategies promoting short term stock price rather than long term corporate value	**Expensing will harm the ability of the company to use option plans, which are a powerful incentive and retention tool that benefits all of our stockholders**

***Source**: Proxy Statements of Firms Targeted by a Shareholder Proposal for Expensing Stock Options*

Appendix 3: Definition of Variables

	Expected relation to *VOTES*
DEPENDENT VARIABLE	
VOTES= Logit transformation of: Votes For / (Votes For + Votes Against). Source: 10Q filed after the annual meeting.	
MAIN EXPLANATORY VARIABLES	
EXCESSOPTCEO= Difference in the ratio (Number of Options held by CEO / Total Shares Outstanding) between each firm and its 'industry&size' median, scaled by the 'industry&size' median. The 'industry&size' median is the median value for all other Execucomp firms in the same industry (defined as in Core and Guay 1999) and within the same size quartile. The Number of Options held by the CEO is obtained from Execucomp, while Total Shares Outstanding are from Compustat (DATA 25).	Positive
EXCESSOPTNONCEO= As *EXCESSOPTCEO*, but with the numerator being the Number of Options Outstanding not held by the CEO. The latter is computed subtracting the options held by the CEO from all the options outstanding.[1]	Positive
OPTEXPENSE= Option expense reported under SFAS 123 (Compustat DATA399) scaled by the year-end market value of equity (Compustat DATA24*DATA25).	Negative
PROFTHRESH= Dummy variable equal to 1 when the option expense reported under SFAS 123 (Compustat DATA399) would have turned a profit (measured as net income before extraordinary items, DATA18) into a loss, and 0 otherwise.	Negative
INSIDEOWN= Percentage of shares held by insiders, adjusted to include any ownership presumably aligned with insiders. For example, The American Financial Group Retirement and Savings Plan ("RASP") owns 12% of American Financial Group and, according to the 2002 proxy statement, "*the members of the Administrative Plan Committee … direct the voting of the securities held by the RASP. Both of the members of such Committee are executives of the Company*". Thus, we add 12% to the insiders' ownership in American Financial Group.[2] We 'adjust' the insiders' ownership figure for 7 firms. Source: Beneficial Ownership Table in Proxy Statements.	Negative
INSTOWN= % of shares held by institutional investors (Source: Thomson Financial).	Unclear

[1] For the sample firms, the total number of options outstanding is hand-collected from the 10K. For the control firms, we divide the number of options held by the CEO by the three-year average of the ratio (# Options Granted to CEO / # Total Options Granted). This proxy assumes that the pattern of option grants and exercises over time is similar for the CEO and all other employees, and that the percentage of total options grants allocated to the CEO is constant over time. We validate our proxy by estimating its correlation with the actual value for our sample of 107 firms. The Pearson correlation is 0.71 (p-value<0.0001).

[2] A particular adjustment was required for Hershey Foods Corp. While insiders formally own 12% of the common stock through the Milton Hershey School Trust (MHST), a footnote in the proxy statement reveals that MHST "*will be entitled to cast 12,276,671 of the total 102,132,277 votes, or 12%, entitled to be cast on matters required to be voted on separately by the holders of the Common Stock, and 315,336,731 of the total 406,355,357 votes, or 77.6%, entitled to be cast by the holders of the Common Stock and the Class B Stock voting together on matters to be voted on without regard to class*" – an example being the option expensing proposal. Thus, insiders de facto controlled 77.6% of the votes on the expensing proposal, hence the very low percentage of votes FOR at Hershey Foods (see Table 1, Panel B). Note that in this case, we also re-scale accordingly the percentage ownership by institutions.

Appendix 3: Definition of Variables (Continuation)

	Expected relation to *VOTES*
CONTROL VARIABLES	
LONGTERM, TRANSIENT = % of shares held, respectively, by 'long-term' ('dedicated' and 'quasi-indexers') and 'transient' institutional investors, defined as in Bushee (1998). Sources: Thomson Financial and 2002 classification provided by Brian Bushee.	Positive (Longterm) Negative (Transient)
ACTIVE = Percentage of shares held by institutional investors classified by Thomson Financial as Type 3 (Investment companies and their managers), Type 4 (Independent investment advisors) or Type 5 (All others—endowment funds, foundations, etc.).[3]	Positive
PASSIVE = Percentage of shares held by institutional investors classified by Thomson Financial as Type 1 (Banks) or Type 2 (Insurance companies).	Negative
SIZE= Total assets of the firm measured in billions of US dollars (Compustat DATA6).	Positive
ADJRET= Industry-adjusted stock returns over the 3-year period leading to the month of shareholders' vote at the annual meting. To account for the large size of the sample firms, industry-adjusted returns are computed as the difference between firm returns and returns on a capitalization-weighted portfolio of firms within the same 2-digit SIC code.	Negative
LEVERAGE= Total debt / Total assets [((DATA9 + DATA 34)/DATA6) in Compustat].	Positive
INTERESTCOVG= Dummy variable equal to 1 if the firm's interest coverage ratio is above the sample median, and 0 otherwise. The interest coverage ratio is computed as pretax income (Compustat DATA170) plus interest expense (DATA15), divided by interest expense. When interest expense is zero, we assume the ratio is greater than the highest ratio in the sample and then construct the INTERESTCOVG dummy.	Positive
CONFLICT= Dummy variable equal to 1 if a conflict of interest on the Compensation Committee is disclosed in the Proxy Statement, and 0 otherwise.[4]	Positive
VOTESWITHHELD= Highest percentage of votes withheld from any director up for re-election at the annual meeting where the ESO expensing proposal is voted upon. Source: 10Q filed after the annual meeting.	Positive
NONAPPROVEQUITY = % of total options outstanding granted under equity compensation plans not submitted to shareholders' approval. Source: Proxy Statements.	Positive
VOLUNTEXP= % of firms in the same industry (as defined by 4-digit SIC codes) that were expensing options at the time shareholders voted on the option expensing proposal. Source: Bear Stearns & Co. Equity Research Report, December 16, 2004.	Positive or no relation
HITECH= Dummy equal to 1 for high tech firms (0 else), defined as in Murphy (2003) (SIC codes: 3570-3572, 3576-3577, 3661, 3674, 4812-4813, 5045, 5961, 7370-7373).	Negative

[3] Because of an error by Thomson Financial, after 1998 many institutions are mistakenly coded as Type 5. For these institutions, we use their pre-1998 code and verify manually its accuracy.

[4] In the proxy statement section "Compensation Committee Interlocks and Insider Participation" firms have to disclose any conflict of interest involving members of their Compensation Committee. A conflict of interest is assumed to exist when: i) insiders sit on the Compensation Committee, or ii) members of the Compensation Committee have a business relationship with the firm (as defined by Item 404 of SEC Reg. S-K), or iii) there are interlocks with members of the Compensation Committee of other firms.

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TABLE 1

Panel A: Sample Selection

	Proxy Season	
	2003	***2004***
Number of shareholder proposals on Option Expensing submitted[1]	***117***	
Less—Proposals withdrawn…		
…due to violation of technical requirements	19	
…because the firm already had a policy of expensing ESOs	3	
Valid shareholder proposals on Option Expensing submitted[1]	***95***	***36***
Less—Proposals withdrawn…		1
… because the firm agreed to expense options[2]	23	
Shareholder proposals voted upon at the annual meeting[3]	***72***	***35***
Final Sample- Shareholder proposals voted upon (2003-2004)		**107**

Notes:

[1] Based on a list provided by UBCJA and complemented/cross-checked with various online sources.

[2] Firms identified through a keyword search in the Proxy Statements of all firms registered at the S.E.C., including the words "Proposal" and "Expensing" within a distance of six words. The list was then verified vis-à-vis online sources (www.thecorporatelibrary.com and www.georgesonshareholder.com).

[3] Firms identified based on a list compiled by Bear Stearns & Co (Equity Research Report, December 16, 2004).

TABLE 1

Panel B: Voting Outcome

Firm Name	Meeting Date	Sponsor[1]	Voting Turnout	Votes FOR as % of votes…			Passed[2]
				for + against + abstained	for + against	for + against - insider	
Alaska Air Group Inc	5/20/2003	Individual	68.3%	50.4%	51.0%	54.3%	Yes
Albertsons Inc /DE/	6/6/2003	IBEW	80.2%	49.6%	51.2%	56.9%	No
Allegheny Energy Inc	11/14/2003	SMWIA	51.2%	39.7%	41.3%	41.4%	**No**
Allied Waste Industries Inc	5/21/2003	SMWIA	83.6%	41.1%	41.8%	69.5%	No
Allmerica Financial Corp	5/13/2003	UBCJA	56.4%	33.8%	34.5%	35.3%	**No**
American Financial Group Inc	6/6/2003	UBCJA	86.6%	20.6%	20.7%	57.9%	**No**
Analog Devices Inc	3/11/2003	UBCJA	77.6%	36.9%	37.8%	39.0%	**No**
Apple Computer Inc	4/24/2003	UBCJA	62.3%	51.8%	56.4%	65.8%	**Yes**
Avon Products Inc	5/1/2003	IBEW	79.9%	55.2%	56.4%	57.1%	**Yes**
Black & Decker Corp	4/29/2003	UBCJA	77.4%	50.8%	52.4%	55.3%	**Yes**
Capital One Financial Corp	4/24/2003	UBCJA	69.2%	67.4%	68.9%	77.1%	Yes
Cheesecake Factory Inc	5/13/2003	CW	62.4%	39.9%	40.7%	45.9%	No
Cincinnati Financial Corp	4/19/2003	LIUNA	70.8%	28.1%	29.1%	42.2%	No
Cintas Corp	10/14/2003	AFSCME	79.1%	32.4%	33.7%	52.4%	**No**
Citrix Systems Inc	5/15/2003	LIUNA	63.2%	53.5%	54.8%	57.6%	Yes
Clayton Homes Inc	10/30/2002	LIUNA	80.0%	28.4%	28.4%	44.1%	**No**
Cobiz Inc	5/21/2003	Individual	72.6%	16.8%	16.8%	37.1%	**No**
Coca Cola Enterprises Inc	4/25/2003	UBCJA	82.5%	26.7%	27.6%	76.6%	**No**
Cognos Inc	6/19/2003	UBCJA	67.2%	53.5%	53.5%	55.4%	Yes
Convergys Corp	4/22/2003	LIUNA	62.3%	47.5%	49.1%	53.7%	No
Delta Air Lines Inc /DE/	4/25/2003	Individual	80.7%	60.2%	61.4%	63.4%	Yes
Donnelley R R & Sons Co	3/27/2003	UBCJA	77.7%	40.2%	41.1%	43.9%	No
Eastman Kodak Co	5/7/2003	LIUNA	67.1%	54.3%	56.3%	57.2%	**Yes**
Equifax Inc	5/14/2003	UBCJA	67.0%	58.6%	60.7%	64.0%	**Yes**
Firstenergy Corp	5/20/2003	SMWIA	76.4%	44.7%	46.6%	46.9%	No
Fluor Corp	5/7/2003	UBCJA	77.4%	78.6%	79.7%	83.0%	Yes
Gap Inc	5/14/2003	SMWIA	86.6%	35.9%	36.4%	59.3%	No
Gateway Inc	5/15/2003	CPF	74.0%	22.4%	22.9%	42.2%	No
Genzyme Corp	5/29/2003	UBCJA	70.7%	61.9%	63.2%	65.8%	**Yes**
Georgia Pacific Corp	5/6/2003	IBT	68.9%	63.2%	65.3%	66.8%	**Yes**
Gillette Co	5/15/2003	UBCJA	74.4%	40.7%	41.9%	48.2%	**No**
Hershey Foods Corp	4/22/2003	UBCJA	92.4%	9.2%	9.3%	62.9%	No
Hewlett Packard Co	4/2/2003	LIUNA	71.0%	43.4%	45.2%	50.1%	No
Intel Corp	5/21/2003	UBCJA	60.3%	47.6%	49.5%	52.6%	No
Intl Business Machines Corp	4/29/2003	UA	60.9%	45.3%	47.3%	47.4%	**No**
Kimberly Clark Corp	4/24/2003	UBCJA	76.6%	50.5%	53.0%	53.8%	Yes
Kinder Morgan Inc	5/8/2003	LIUNA	75.7%	30.6%	31.2%	45.1%	No
Knight Ridder Inc	4/22/2003	Individual	85.1%	48.3%	49.5%	51.4%	**No**
Kohls Corporation	5/1/2003	UBCJA	82.9%	49.6%	50.6%	59.6%	**Yes**
Lilly Eli & Co	4/28/2003	UBCJA	76.6%	39.7%	41.3%	51.2%	**No**
MBNA Corp	5/6/2003	AFSCME	77.3%	50.8%	52.1%	66.1%	**Yes**
Marriott International Inc /MD	5/2/2003	IBEW	80.5%	31.9%	33.2%	43.1%	No
Maximus Inc	3/18/2003	ABL	86.6%	40.2%	40.3%	48.3%	**No**
Mercury Interactive Corp	5/15/2003	UBCJA	78.6%	51.6%	52.3%	59.6%	Yes

TABLE 1

Panel B: Voting Outcome (Continuation)

Firm Name	Meeting Date	Sponsor[1]	Voting Turnout	Votes for as % of votes…			Passed[2]
				for + against + abstained	for + against	for + against - insider	
Mirant Corp	5/22/2003	IBEW	37.3%	60.5%	61.7%	64.7%	**Yes**
NCR Corp	4/23/2003	LIUNA	68.7%	51.0%	53.2%	56.1%	**Yes**
Nordstrom Inc	5/20/2003	SMWIA	74.1%	41.0%	41.9%	70.8%	**No**
Otter Tail Corp	4/14/2003	Individual	70.0%	32.5%	34.1%	35.1%	**No**
PP&E Corp	4/16/2003	UBCJA	70.2%	49.6%	56.2%	58.2%	No
PPG Industries Inc	4/17/2003	IBT	69.7%	49.2%	52.4%	53.4%	**Yes**
J C Penney Co Inc	5/16/2003	LIUNA	80.7%	46.1%	51.7%	52.4%	**Yes**
Peoplesoft Inc	5/27/2003	AFSCME/ CRP	74.6%	46.7%	47.8%	56.8%	No
Progress Energy Inc	5/14/2003	UBCJA	69.6%	43.5%	45.0%	45.6%	**No**
Providian Financial Corp	5/1/2003	SMWIA	62.7%	51.6%	54.5%	56.2%	Yes
SWS Group Inc	11/6/2002	SMWIA	58.6%	26.9%	30.1%	73.0%	No
Safeway Inc	5/15/2003	UA	73.3%	61.2%	62.7%	67.4%	Yes
Schwab Charles Corp	5/9/2003	SMWIA	73.8%	28.2%	28.9%	41.5%	No
Siebel Systems Inc	6/11/2003	AFSCME	56.5%	31.7%	32.7%	45.7%	No
Starbucks Corp	3/25/2003	UBCJA	66.7%	41.0%	42.3%	46.5%	**No**
Starwood Hotel & Resorts Worldwide Inc	5/9/2003	IBEW	83.1%	59.0%	60.5%	64.8%	**Yes**
Supervalu Inc	5/29/2003	UBCJA	76.3%	60.8%	64.3%	66.8%	Yes
Teco Energy Inc	4/22/2003	UBCJA	53.0%	45.8%	47.4%	49.0%	No
Thermo Electron Corp	5/14/2003	SMWIA	82.1%	58.4%	59.7%	62.1%	Yes
US Bancorp \DE\	4/15/2003	UBCJA	67.1%	57.3%	59.9%	61.9%	Yes
Unitedhealth Group Inc	5/7/2003	AFSCME	82.1%	47.1%	48.1%	51.4%	No
Vectren Corp	5/14/2003	UBCJA	71.7%	42.5%	44.3%	47.9%	**No**
Veritas Software Corp /DE/	5/13/2003	UA	72.9%	62.8%	64.3%	66.9%	Yes
Wells Fargo & Co/MN	4/22/2003	Individual	73.5%	56.3%	58.8%	59.7%	Yes
Weyerhaeuser Co	4/15/2003	IBT	80.5%	50.0%	51.4%	53.7%	**Yes**
Yahoo Inc	5/16/2003	UBCJA	71.2%	33.7%	34.4%	45.9%	No
Zimmer Holdings Inc	5/13/2003	IBEW	87.0%	39.2%	47.0%	47.5%	No
Adobe Systems Inc	4/28/2004	UBCJA	75.1%	58.0%	59.4%	62.8%	**Yes**
Allegheny Energy Inc	5/13/2004	Individual	60.3%	46.4%	47.6%	47.7%	**No**
Allergan Inc	4/28/2004	UBCJA	78.7%	61.3%	62.2%	63.6%	Yes
Allied Waste Industries Inc	5/21/2004	SMWIA	88.6%	38.9%	39.5%	69.1%	**No**
American Eagle Outfitters Inc	6/22/2004	Individual	74.1%	44.5%	45.2%	78.3%	No
American Financial Group Inc	5/25/2004	UBCJA	85.9%	24.2%	24.4%	64.9%	**No**
Amgen Inc	5/13/2004	SEIU	65.0%	59.6%	61.5%	62.1%	Yes
Cintas Corp	10/19/2004	AFSCME	81.4%	34.5%	35.1%	45.6%	**No**
Citrix Systems Inc	5/13/2004	UBCJA	62.1%	68.8%	70.2%	73.9%	Yes
Dell Inc	7/16/2004	AFL CIO	71.7%	44.0%	45.2%	53.3%	No
R.R. Donnelley & Sons Co	4/14/2004	UA	62.2%	53.3%	54.8%	58.1%	Yes
Ebay Inc	6/24/2004	IBEW	83.9%	39.0%	39.9%	61.5%	No
El Paso Corp/DE	11/18/2004	AICF/UA	68.3%	68.8%	70.8%	72.2%	**Yes**
Firstenergy	5/18/2004	UBCJA	75.4%	53.2%	55.2%	55.4%	**Yes**
Gillette Co	5/20/2004	UA	75.0%	41.1%	48.4%	48.5%	**No**

TABLE 1

Panel B: Voting Outcome (Continuation)

Firm Name	Meeting Date	Sponsor[1]	Voting Turnout	Votes for as % of votes…			Passed[2]
				for + against + abstained	for + against	for + against - insider	
Guidant Corp	5/18/2004	UA	78.3%	62.4%	63.7%	66.1%	**Yes**
Hewlett-Packard Co	3/17/2004	UBCJA	72.1%	55.2%	56.9%	62.1%	Yes
Intel Corp	5/19/2004	UBCJA	64.4%	54.5%	56.6%	59.9%	Yes
Intl Business Machine Corp	4/27/2004	UA	61.2%	51.5%	53.6%	53.7%	**Yes**
Kinder Morgan Inc	5/11/2004	CLPWAF	68.9%	41.4%	42.2%	63.7%	No
Laurel Capital Group Inc	10/28/2004	Individual	61.7%	23.5%	29.2%	45.2%	No
MBNA Corp	5/3/2004	AFSCME	77.8%	56.5%	57.8%	67.7%	**Yes**
Novell Inc	4/15/2004	UBCJA	65.1%	58.8%	60.7%	62.2%	Yes
Peoplesoft	3/24/2004	AFSCME	68.8%	52.9%	53.9%	63.7%	Yes
Perkinelmer Inc	4/27/2004	UBCJA	76.9%	59.8%	61.3%	70.6%	**Yes**
Raytheon Co	5/5/2004	AFL CIO	73.9%	64.5%	66.5%	67.5%	Yes
Safeway Inc	5/20/2004	UA	77.8%	50.7%	51.4%	54.8%	**Yes**
Siebel Systems Inc	6/23/2004	UBCJA	64.2%	49.1%	54.3%	73.0%	No
Teco Energy Inc	4/28/2004	UBCJA	60.8%	47.4%	48.7%	50.3%	No
Texas Instruments Inc	4/15/2004	UBCJA	74.3%	57.3%	58.8%	59.4%	Yes
Unitedhealth Group Inc	5/12/2004	AFSCME	80.4%	51.5%	52.7%	55.9%	Yes
Vectren Corp	4/28/2004	SMWIA	62.0%	43.6%	45.4%	48.5%	**No**
Wells Fargo & Co/Mn	4/27/2004	Individual	74.1%	58.2%	59.8%	60.5%	Yes
Weyerhauser Co	4/13/2004	UBCJA	76.1%	62.4%	63.5%	66.8%	**Yes**
Yahoo! Inc	5/21/2004	UBCJA	72.2%	45.0%	45.9%	58.2%	No
AVERAGE			**72.5%**	**47.0%**	**48.6%**	**56.9%**	**51 Yes, 56 No**

Notes:

[1] The sponsors' acronyms correspond to:

ABL:	Amalgamated Bank Longview SmallCap 600 Index Fund
AFL CIO:	AFL-CIO Reserve Fund
AFSCME:	American Federation of State, County and Municipal Employees Pension
AFSCME/CRP:	AFSCME Employees Pension Plan and the Connecticut Retirement Plans
AICF/UA:	The Advisors' Inner Circle Fund/ United Association S&P 500 Index Fund
CLPWAF:	Central Laborers Pension, Welfare & Annuity Funds
CPF:	Central Pension Fund of the Intl Union of Operating Businesses and Participating Employees
CW:	Culinary Workers Union Local 226
IBEW:	International Brotherhood of Electrical Workers' Pension Benefit Fund
IBT:	International Brotherhood of Teamsters
Individual:	Individual
LIUNA:	Laborers' International Union of North America
SMWIA:	Sheet Metal Workers' International Association
SEIU:	SEIU Master Trust
UA:	United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry
UBCJA:	United Brotherhood of Carpenters and Joiners of America

[2] In some firms (bolded in the right-most column), the approval rule called for votes FOR to exceed the sum of votes FOR, AGAINST and ABSTAINED, while in the other firms (not bolded), it only required votes FOR to exceed votes AGAINST.

TABLE 2
Characteristics of Firms Targeted by ESO Expensing Proposal

Panel A: Industry Classification

Industry (based on Core and Guay 1999)	Compustat firms		Targeted firms	
	# of firms	%	# of firms	%
Mining, Oil and Gas	422	4.30	1	0.65
Construction and Real Estate	175	1.78	2	1.31
Food	164	1.67	4	2.61
Tobacco	12	0.12	0	0.00
Consumer Products	229	2.33	2	1.31
Lumber, Wood, Paper and Printing	132	1.34	7	4.58
Media (publishing, radio, TV, motion pictures)	375	3.82	4	2.61
Chemicals	194	1.98	4	2.61
Drugs and medicinal chemicals	493	5.02	4	2.61
Petroleum refining and related industries	48	0.49	1	0.65
Rubber, plastics, stone, glass, concrete, metal	333	3.39	3	1.96
Industrial machinery, electronics and equipment	1359	13.84	18	11.76
Computer hardware	173	1.76	4	2.61
Computer software	931	9.48	17	11.11
Motor vehicles (cars, buses, trucks)	101	1.03	0	0.00
Aircraft and parts	29	0.30	0	0.00
Transit and transportation	241	2.45	4	2.61
Utilities	611	6.22	31	20.26
Wholesale	291	2.96	1	0.65
Retail	487	4.96	10	6.54
Banks and other savings and credit institutions	916	9.33	13	8.50
Other financial institutions	1276	12.99	18	11.76
Recreation and lodging	35	0.36	2	1.31
Services (health, legal, social, etc.)	793	8.08	3	1.96
Total	**9820**	**100%**	**153**	**100%**

Chi-Square Test: Chi -Square= 89.6 | Degrees of Freedom=23 | Pr>ChiSq=<0.001

Panel B: Characteristics of targeted firms relative to population and S&P 500 firms

Variable	Means		Difference in means	T-test (Pr>t)	Means		Difference in means	T-test (Pr>t)
	Targeted Sample	Population[1]			Targeted Sample	S&P 500[2]		
SIZE	27086	5343	**21742**	**<0.001**	27086	14609	**12477**	**0.009**
LEVERAGE	0.267	0.268	-0.001	0.936	0.267	0.243	0.024	0.167
MB _RATIO	4.009	3.576	0.433	0.765	4.009	3.709	0.300	0.728
RETURNS	0.025	0.111	-0.086	0.108	0.025	0.050	-0.025	0.708
INSTOWN	0.647	0.252	**0.395**	**<0.001**	0.647	0.683	**-0.036**	**0.022**
EXECOWN	0.006	0.009	**-0.003**	**0.010**	0.006	0.004	0.002	0.115
OPTEXPENSE	0.009	0.174	**-0.165**	**0.071**	0.009	0.013	**-0.004**	**0.088**
PROFTHRESH	0.052	0.058	-0.006	0.765	0.052	0.024	0.028	0.165
EXECONBOARD	0.281	0.303	-0.022	0.105	0.281	0.299	-0.018	0.275
OPTCEO	0.010	0.017	**-0.007**	**<0.001**	0.010	0.009	0.001	0.838
DILUTION	0.110	0.123	-0.013	0.227	0.110	0.099	0.011	0.157
UNION	0.131	n.a.			0.131	0.116	0.015	0.354

TABLE 2
Characteristics of Firms Targeted by ESO Expensing Proposal

Panel C : Probit Model comparing sample with S&P 500 firms[2]

	Dep. Variable=1 if Firm Targeted		Dep. Variable=1 if Firm Received Vote	
Constant	**-1.212**	**-1.195**	-0.998	-1.008
p-value	0.061	0.065	0.159	0.154
DILUTION	**0.025**		**0.029**	
p-value	0.010		0.010	
OPTCEO		**0.137**		**0.172**
p-value		0.055		0.023
OPTEXPENSE	**-9.683**	-6.757	**-10.336**	-7.477
p-value	0.057	0.136	0.052	0.116
EXECOWN	**0.150**	**0.152**	**0.186**	**0.192**
p-value	0.024	0.022	0.008	0.007
INSTOWN	**-0.981**	**-0.997**	-0.751	-0.768
p-value	0.023	0.022	0.112	0.106
LNSIZE	**0.120**	**0.131**	0.067	0.084
p-value	0.032	0.021	0.275	0.177
MB_ RATIO	0.005	0.006	-0.006	-0.003
p-value	0.509	0.424	0.692	0.805
RETURNS	0.045	0.022	-0.080	-0.104
p-value	0.695	0.851	0.548	0.436
LEVERAGE	0.563	0.445	0.384	0.178
p-value	0.211	0.320	0.453	0.727
EXECONBOARD	**-0.819**	**-0.725**	**-1.018**	**-1.005**
p-value	0.059	0.089	0.043	0.045
HITECH	**0.502**	**0.586**	**0.489**	**0.596**
p-value	0.018	0.004	0.030	0.006
UNION	0.003	0.002	0.004	0.004
p-value	0.501	0.579	0.395	0.405
Pseudo R-square (N)	*0.065 (438)*	*0.060 (438)*	*0.069 (400)*	*0.066 (400)*

Notes:

[1] The population includes all firms with the available data in Compustat (financial variables), CRSP (stock returns), Execucomp (compensation and governance variables), Thomson Financial (institutional ownership), except the targeted firms and firms voluntarily expensing ESO as of the end of 2002.

[2] The S&P500 sample includes all firms in the S&P 500 Index except firms targeted by the ESO expensing proposal and firms voluntarily expensing ESO as of the end of 2002.

DILUTION = Total options outstanding divided by total shares outstanding.
EXECONBOARD = Fraction of top 5 executives sitting on the Board of directors.
EXECOWN = Percentage of shares held by Top 5 executives.
HITECH = Dummy equal to 1 for firms in high tech industry, 0 otherwise.
INSTOWN= Percentage of shares held by institutional investors.
LEVERAGE = Total debt divided by total assets.
MB_RATIO = Market to book value of equity ratio.
OPTCEO = CEO option holdings (scaled by total shares outstanding).
OPTEXPENSE = Option expense scaled by market value of equity.
PROFTHRESH = Dummy equal to 1 if recognizing the option expense would turn a profit into a loss, 0 else.
RETURNS = Stock returns over the 3-year period before the shareholders' vote.
SIZE = Total assets of the firm (billion $) - *LNSIZE*= Natural logarithm of *SIZE*.
UNION =Percentage of employees unionized, calculated using firm-level data from the 10-Ks where available (approx. 50% of the cases), else proxied by the industry average (Source: Bureau of Labor Economics).

TABLE 3
Determinants of Shareholders' Votes on Option Expensing Proposals

Panel A: Descriptive Statistics

Variable	N	Mean	Percentile				
			10th	25th	50th	75th	90th
VOTESFOR	106	0.486	0.301	0.413	0.508	0.578	0.632
EXCESSOPTCEO	107	0.490	-0.908	-0.579	-0.049	0.803	2.279
OPTEXPENSE	107	0.011	0.001	0.003	0.004	0.010	0.031
PROFTHRESH	107	0.075	-	-	-	-	-
INSIDEOWN	107	0.105	0.008	0.018	0.040	0.149	0.308
INSTOWN	107	0.652	0.416	0.563	0.664	0.773	0.858
LONGTERM	107	0.383	0.239	0.321	0.378	0.458	0.523
TRANSIENT	107	0.250	0.120	0.184	0.252	0.307	0.371
ACTIVE	107	0.517	0.316	0.428	0.529	0.606	0.692
PASSIVE	107	0.146	0.085	0.100	0.148	0.183	0.210
SIZE	107	23.1	1.3	2.9	8.6	20.2	44.2
ADJRET	103	-0.213	-0.868	-0.591	-0.243	0.055	0.416
LEVERAGE	107	0.238	0.006	0.064	0.227	0.366	0.491
INTERESTCOVG	107	0.505	-	-	-	-	-
CONFLICT	107	0.196	-	-	-	-	-
VOTESWITHHELD	106	0.117	0.027	0.044	0.079	0.176	0.263
NONAPPROVEQUITY	107	0.130	0	0	0.012	0.195	0.418
VOLUNTEXP	107	0.043	0	0	0.019	0.071	0.111
HITECH	107	0.234	-	-	-	-	-

TABLE 3 Determinants of Shareholders' Votes on Option Expensing Proposals (Continuation)

Panel B: Pearson Correlation Coefficients[1]

	VOTESFOR	*EXCESSOPTCEO*	*OPTEXPENSE*	*PROFTHRESH*	*INSIDEOWN*	*INSTOWN*	*SIZE*	*ADJRET*	*LEVERAGE*	*INTERESTCOVG*	*CONFLICT*	*VOTESWITHHELD*	*NONAPPROVEQUITY*	*VOLUNTEXP*
EXCESSOPTCEO	**0.252** *0.009*													
OPTEXPENSE	0.057 *0.564*	**0.414** *<0.001*												
PROFTHRESH	-0.017 *0.860*	**0.274** *0.004*	**0.536** *<0.001*											
INSIDEOWN	**-0.737** *<0.001*	-0.101 *0.300*	-0.038 *0.697*	-0.021 *0.826*										
INSTOWN	**0.594** *<0.001*	**0.305** *0.001*	0.070 *0.474*	0.071 *0.467*	**-0.509** *<0.001*									
SIZE	**0.179** *0.066*	-0.101 *0.298*	-0.128 *0.189*	-0.079 *0.416*	-0.148 *0.127*	-0.066 *0.499*								
ADJRET	-0.155 *0.118*	0.023 *0.816*	**-0.266** *0.006*	-0.142 *0.153*	0.066 *0.506*	-0.015 *0.884*	-0.011 *0.914*							
LEVERAGE	**0.185** *0.058*	-0.079 *0.417*	**-0.256** *0.008*	**-0.178** *0.066*	-0.141 *0.149*	0.076 *0.439*	0.015 *0.877*	-0.099 *0.319*						
INTERESTCOVG	0.115 *0.239*	0.004 *0.964*	0.035 *0.720*	0.068 *0.484*	-0.052 *0.593*	0.094 *0.335*	0.148 *0.127*	**0.259** *0.008*	**-0.505** *<0.001*					
CONFLICT	-0.082 *0.401*	-0.019 *0.846*	0.015 *0.880*	-0.051 *0.602*	0.117 *0.228*	-0.070 *0.475*	**0.312** *0.001*	-0.002 *0.984*	-0.121 *0.214*	0.066 *0.500*				
VOTESWITHHELD	**0.354** *0.000*	0.097 *0.321*	-0.001 *0.989*	-0.046 *0.642*	**-0.208** *0.032*	**0.277** *0.004*	**0.289** *0.002*	-0.135 *0.173*	-0.002 *0.982*	0.103 *0.295*	**0.191** *0.049*			
NONAPPROVEQUITY	**0.230** *0.018*	0.142 *0.144*	**0.196** *0.043*	0.065 *0.505*	**-0.189** *0.051*	0.068 *0.488*	**0.225** *0.020*	-0.047 *0.639*	**-0.214** *0.027*	0.101 *0.302*	0.034 *0.725*	0.135 *0.169*		
VOLUNTEXP	-0.138 *0.159*	-0.132 *0.176*	**-0.250** *0.009*	-0.128 *0.189*	0.066 *0.498*	-0.118 *0.226*	0.136 *0.162*	0.100 *0.314*	0.114 *0.242*	-0.116 *0.235*	**0.168** *0.083*	0.034 *0.727*	**-0.198** *0.041*	
HITECH	0.068 *0.489*	**0.164** *0.091*	**0.591** *<0.001*	**0.431** *<0.001*	-0.075 *0.441*	-0.044 *0.650*	-0.021 *0.828*	0.040 *0.688*	**-0.453** *<0.001*	**0.326** *0.001*	-0.106 *0.277*	0.011 *0.913*	**0.280** *0.003*	**-0.364** *<0.001*

Notes: (see Appendix 3 for details on variables definition)

[1] The significance of the Pearson correlations between each pair of variables is indicated in *italics* under the correlation value.

VOTESFOR = Votes For / (Votes For + Votes Against).
EXCESSOPTCEO = CEO option holdings (scaled by total shares) relative to firms of similar size in same industry.
OPTEXPENSE = Option expense scaled by market value of equity.
PROFTHRESH = Dummy equal to 1 if recognizing the option expense would have turned a profit into a loss, 0 else.
INSIDEOWN, INSTOWN = % of shares held by, respectively, insiders and institutional investors.
LONGTERM, TRANSIENT = % of shares held by, respectively 'long-term' ('dedicated' plus 'quasi-indexers'), and 'transient' institutional investors, classified as per Bushee (1998).
ACTIVE = Percentage of shares held by institutional investors with lower probability of actual or potential business ties with the firm based on the Thomson Financial classification (investment companies, independent investment advisors, others - endowment funds, foundations, etc.)
PASSIVE = Percentage of shares held by institutional investors with higher probability of actual or potential business ties with the firm (banks, insurance companies).
SIZE = Total assets of the firm (billion $).
ADJRET = Industry-adjusted stock returns over the 3-year period before the shareholders' vote.
LEVERAGE = Total debt divided by total assets.
INTERESTCOVG = Dummy variable equal to 1 if the interest coverage ratio is above the sample median, 0 else.
CONFLICT = Dummy variable equal to 1 if a conflict of interest on the Compensation Committee is disclosed in the Proxy Statement, 0 otherwise.
VOTESWITHHELD= Highest percentage of votes withheld from any director up for re-election at the annual meeting where the ESO expensing proposal is voted upon.
NONAPPROVEQUITY = Fraction of total options outstanding which was granted under equity compensation plans not submitted to shareholders for approval.
VOLUNTEXP = % of firms in the same industry that were expensing options at the time shareholders voted on the option expensing proposal.
HITECH= Dummy equal to 1 for firms in high tech industry, 0 otherwise.

TABLE 4
Determinants of Shareholders' Votes on Option Expensing Proposals

Panel A: OLS Regression[1]

Dependent Variable	***VOTES***						***NONINSIDER_VOTES***	
Model	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Constant	**-0.978**	**-1.062**	**-0.956**	**-1.058**	**-0.858**	**-0.934**	**-0.720**	**-0.783**
p-value	<0.001	<0.001	<0.001	<0.001	<0.001	<0.001	0.017	0.008
EXCESSOPTCEO	**0.048**	**0.042**	**0.048**	**0.042**	**0.048**	**0.042**	**0.064**	**0.061**
p-value	0.002	0.002	0.002	0.002	0.002	0.002	0.002	<0.001
OPTEXPENSE	**-5.439**		**-5.330**		**-5.189**		**-4.216**	
p-value	0.026		0.027		0.033		0.094	
PROFTHRESH		**-0.221**		**-0.233**		**-0.219**		**-0.272**
p-value		0.087		0.079		0.088		0.068
INSIDEOWN	**-2.030**	**-2.051**	**-2.101**	**-2.121**	**-2.269**	**-2.277**	**1.246**	**1.242**
p-value	<0.001	<0.001	<0.001	<0.001	<0.001	<0.001	0.009	0.009
INSTOWN	**0.869**	**0.852**					0.463	**0.466**
p-value	<0.001	<0.001					0.110	0.099
LONGTERM			**0.794**	**0.723**				
p-value			0.045	0.051				
TRANSIENT			**0.905**	**0.961**				
p-value			0.006	0.004				
ACTIVE					**0.754**	**0.732**		
p-value					<0.001	<0.001		
PASSIVE					1.001	1.056		
p-value					0.128	0.109		
LNSIZE	0.025	0.035	0.029	0.040	0.020	0.028	0.033	0.038
p-value	0.308	0.157	0.266	0.107	0.457	0.295	0.312	0.214
ADJRET	**-0.149**	**-0.124**	**-0.150**	**-0.127**	**-0.149**	**-0.127**	**-0.158**	**-0.148**
p-value	0.035	0.067	0.035	0.062	0.045	0.073	0.075	0.074
LEVERAGE	**0.613**	**0.613**	**0.589**	**0.599**	**0.548**	**0.547**	**0.606**	**0.612**
p-value	0.029	0.025	0.041	0.033	0.055	0.050	0.092	0.082
INTERESTCOVG	**0.139**	**0.151**	0.136	**0.152**	0.120	0.129	0.152	0.161
p-value	0.095	0.061	0.120	0.063	0.172	0.129	0.164	0.133
CONFLICT	0.029	0.004	0.214	-0.003	0.027	0.002	-0.053	-0.071
p-value	0.736	0.961	0.808	0.977	0.761	0.983	0.644	0.545
VOTESWITHHELD	**0.456**	**0.451**	**0.436**	**0.412**	**0.505**	**0.503**	**0.603**	**0.576**
p-value	0.047	0.046	0.071	0.088	0.037	0.036	0.027	0.032
NONAPPROVEQUITY	0.163	0.128	0.159	0.120	0.151	0.117	0.158	0.126
p-value	0.296	0.407	0.305	0.434	0.337	0.449	0.373	0.453
VOLUNTEXP	-0.006	-0.006	-0.006	-0.005	-0.006	-0.006	-0.013	-0.012
p-value	0.494	0.500	0.538	0.553	0.531	0.542	0.273	0.291
HITECH	0.185	0.130	0.179	0.128	0.182	0.133	0.081	0.069
p-value	0.127	0.243	0.144	0.248	0.137	0.231	0.576	0.616
Adjusted R^2	0.776	0.775	0.776	0.777	0.772	0.772	0.319	0.332
N	103	103	103	103	103	103	103	103

TABLE 4 (Continuation)
Determinants of Shareholders' Votes on Option Expensing Proposals

Panel B: OLS Regression (Second-Step Heckman)[2]

Dependent Variable	***VOTES***						***NONINSIDER_VOTES***	
Model	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Constant	**-0.950**	**-1.038**	**-0.893**	**-0.994**	**-0.760**	**-0.825**	**-0.852**	**-0.921**
p-value	0.003	0.001	0.006	0.002	0.036	0.022	0.047	0.028
EXCESSOPTCEO	**0.049**	**0.042**	**0.049**	**0.042**	**0.049**	**0.042**	**0.064**	**0.061**
p-value	0.002	0.004	0.002	0.004	0.003	0.005	0.002	0.001
OPTEXPENSE	**-5.500**		**-5.390**		**-5.200**		-4.284	
p-value	0.046		0.050		0.064		0.235	
PROFTHRESH		**-0.221**		**-0.233**		**-0.218**		**-0.272**
p-value		0.050		0.039		0.056		0.062
INSIDEOWN	**-2.027**	**-2.047**	**-2.107**	**-2.128**	**-2.286**	**-2.297**	**1.448**	**1.444**
p-value	<0.001	<0.001	<0.001	<0.001	<0.001	<0.001	<0.001	<0.001
INSTOWN	**0.858**	**0.840**					0.421	0.423
p-value	<0.001	<0.001					0.112	0.107
LONGTERM			**0.799**	**0.727**				
p-value			0.017	0.029				
TRANSIENT			**0.896**	**0.955**				
p-value			0.005	0.003				
ACTIVE					**0.735**	**0.717**		
p-value					0.001	0.001		
PASSIVE					1.075	1.146		
p-value					0.127	0.103		
LNSIZE	0.026	0.035	0.028	**0.039**	0.018	0.024	0.039	0.045
p-value	0.258	0.108	0.258	0.098	0.526	0.370	0.203	0.128
ADJRET	**-0.142**	**-0.116**	**-0.142**	**-0.119**	**-0.142**	**-0.119**	**-0.153**	**-0.142**
p-value	0.009	0.021	0.009	0.018	0.011	0.021	0.032	0.030
LEVERAGE	**0.528**	**0.529**	**0.501**	**0.512**	**0.459**	**0.458**	**0.518**	**0.524**
p-value	0.010	0.010	0.017	0.014	0.030	0.030	0.060	0.054
INTERESTCOVG	**0.146**	**0.158**	**0.146**	**0.163**	**0.129**	**0.139**	**0.162**	**0.171**
p-value	0.035	0.022	0.042	0.022	0.067	0.047	0.072	0.055
CONFLICT	0.027	0.002	0.018	-0.007	0.021	-0.004	-0.064	-0.081
p-value	0.702	0.974	0.804	0.921	0.771	0.957	0.491	0.367
VOTESWITHHELD	0.417	0.411	0.402	0.377	**0.486**	**0.483**	0.521	0.494
p-value	0.138	0.145	0.158	0.187	0.093	0.094	0.153	0.172
NONAPPROVEQUITY	0.068	0.031	0.067	0.027	0.057	0.024	0.056	0.022
p-value	0.659	0.837	0.663	0.858	0.713	0.876	0.780	0.910
VOLUNTEXP	-0.007	-0.007	-0.006	-0.006	-0.007	-0.007	**-0.015**	**-0.014**
p-value	0.204	0.206	0.252	0.264	0.250	0.258	0.050	0.058
HITECH	0.177	0.122	0.163	0.109	0.160	0.108	0.093	0.080
p-value	0.123	0.237	0.162	0.293	0.182	0.314	0.534	0.546
LAMBDA	0.014	0.016	-0.010	-0.011	-0.026	-0.033	0.119	0.121
p-value	0.926	0.916	0.951	0.944	0.879	0.846	0.569	0.558
N	99	99	99	99	99	99	99	99

Notes: (see Appendix 3 for details on variables definition)

[1] Robust standard errors corrected for clustering (due to firms with a vote in both 2003 and 2004).
[2] Results for the First Step (Probit Regression) of the Two-Step Heckman Procedure are presented in Table 2, Panel C, Column 3

VOTES= log [*VOTESFOR*/(1-*VOTESFOR*)] where *VOTESFOR*= Votes For /(Votes For + Votes Against).
NONINSIDER_VOTES= log [*NONINSVOTESFOR/(1-NONINSVOTESFOR*)] where
NONINSVOTESFOR= Votes For /(Votes For + Votes Against – Votes Insiders).
EXCESSOPTCEO = CEO option holdings (scaled by total shares) relative to firms of similar size in same industry.
OPTEXPENSE = Option expense scaled by market value of equity.
PROFTHRESH = Dummy equal to 1 if recognizing the option expense would have turned a profit into a loss, 0 else.
INSIDEOWN= Percentage of shares held by insiders.
INSTOWN= Percentage of shares held by institutional investors.
LONGTERM, TRANSIENT = % of shares held by, respectively 'long-term' ('dedicated' plus 'quasi-indexers'), and 'transient' institutional investors, classified as per Bushee (1998).
ACTIVE = Percentage of shares held by institutional investors with lower probability of actual or potential business ties with the firm based on the Thomson Financial classification (investment companies, independent investment advisors, others - endowment funds, foundations, etc.)
PASSIVE = Percentage of shares held by institutional investors with higher probability of actual or potential business ties with the firm (banks, insurance companies).
LNSIZE= Natural logarithm of total assets of the firm (billion $).
ADJRET = Industry-adjusted stock returns over the 3-year period before the shareholders' vote.
LEVERAGE = Total debt divided by total assets.
INTERESTCOVG = Dummy variable equal to 1 if the firm's interest coverage ratio is above the sample median, 0 otherwise.
CONFLICT = Dummy variable equal to 1 if a conflict of interest on the Compensation Committee is disclosed in the Proxy Statement, 0 otherwise.
VOTESWITHHELD = Highest percentage of votes withheld from any director up for re-election at the annual meeting where the ESO expensing proposal is voted upon.
NONAPPROVEQUITY = Fraction of total options outstanding which was granted under equity compensation plans <u>not</u> submitted to shareholders for approval.
VOLUNTEXP = % of firms in the same industry that were expensing options at the time shareholders voted on the option expensing proposal.
HITECH= Dummy equal to 1 for firms in high tech industry, 0 otherwise.
LAMBDA= Inverse Mill's Ratio computed from first-step Probit regression in Table 2, Panel C, column 3.