

# 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 describe the characteristics of targeted firms and 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. Insiders' ownership is negatively associated to votes *for* in general, but positively related to votes *for* cast by non-insider shareholders, while most types of institutional investors, except those with potential conflicts of interest, tend to vote *for* expensing. Finally, votes *for* are higher in larger firms, with higher interest coverage, higher leverage and lower returns.

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*“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. had allowed shareholders to vote on an accounting matter.<sup>1</sup> This decision came at a time—collapse of the technology sector, high profile accounting scandals—when the accounting treatment for ESO—already hotly debated in the early 1990s<sup>2</sup>—had become the target of strong criticism. In particular, it was argued that lack of ESO expensing had led to excessive option-based compensation (e.g. Bodie et al., 2003), and the latter, in turn, had *“perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising”* (Greenspan, 2002), ultimately resulting in accounting frauds and restatements. In this environment, standard-setters, regulators, legislators, capital market intermediaries, investors and numerous firms began to reconsider, directly or indirectly, the accounting treatment for ESO (see Appendix 1).

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<sup>1</sup> 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 accounting choices – can be excluded from the proxy statements. Based on this rule, the S.E.C. initially let firms exclude ESO expensing proposals, and then in December 2002 reversed its position (see Appendix 1).

<sup>2</sup> 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 of the Statement of Financial Accounting Standards (SFAS) No.123 (1995), which essentially allowed firms to choose between recognition and disclosure of the ESO expense.

In this study we analyze the characteristics of firms targeted by shareholder proposals to expense ESO, discuss the motives of the union funds that submitted most of these proposals, and provide evidence on shareholders' views on ESO expensing by examining the determinants of the voting outcome at a sample of 107 firms. In particular, we hypothesize and find that (i) votes in favor of ESO expensing are positively related to the magnitude of perceived excessive option compensation, and negatively related to the expected earnings impact of expensing ESO, and (ii) insiders' ownership is negatively related to votes for ESO expensing, but positively related to votes cast by non-insider shareholders. We also predict different voting patterns for different types of institutional investors. We hypothesize that "long-term value" oriented institutional investors will vote in favor of ESO expensing, while "short-term earnings" oriented institutional investors will vote against, but find instead support for ESO expensing across both types of institutional investors. We also predict that institutional investors potentially having business dealings with their portfolio firms are more likely to vote against the proposal, while institutions with less potential for conflicts of interests tend to vote in favor. Our results indicate that ESO expensing is supported by the second type of institutional investors but not by the first type.

Finally, we document that support for ESO expensing tends to be higher in larger firms, in firms characterized by lower stock returns, and in firms with higher leverage and interest coverage ratios, consistent with visibility, past performance and contracting costs playing a significant role in shareholders' voting decisions.

Our work contributes to two streams of research in accounting related to ESO expensing and the political process underlying standard setting. 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., 2003a)—focusing mostly on issues of signaling and transparency—our study provides a unique opportunity to explore those arguments from the *perspective of shareholders*—the ultimate users of financial statements—in a context where managers oppose ESO expensing. In this respect, our study is close to Espahbodi et al. (2002), who analyze cross-sectional stock price reactions to FASB deliberations on ESO expensing in the early 1990s, with the key difference that we infer shareholders’ preferences from their voting decision rather than from stock price changes.<sup>3</sup> The second stream of relevant accounting research comprises the studies on the political process of standard setting (Watts and Zimmermann, 1990). For example, Dechow et al. (1996) analyze the characteristics of firms that in the early 1990s lobbied against the ESO expensing proposal by submitting comment letters to the FASB. We contribute to this research by providing first evidence on an alternative, novel lobbying mechanism —shareholder votes—that may be used to gather and formalize other investors’ support, generate media attention and, thus, influence the standard setting process. FASB’s recent decision to re-examine the accounting for pensions may well create another opportunity for shareholder proposals to be a powerful lobbying mechanism.

Further, our study contributes to the growing literature on shareholder activism. In this respect, the ESO expensing proposal exemplifies the emerging role of shareholder activism as a driver for structural governance reforms in the post-Enron era. Through their “power to embarrass” (Norris, 2004), shareholders’ votes at the annual meeting are becoming a

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<sup>3</sup> Stock price changes (i.e. the underlying trading behavior) are likely to be a more credible proxy for shareholders’ revealed preferences relative to the votes cast at the annual meeting. However, the voting outcome is likely to be less subject to measurement error, resulting in a cleaner proxy for shareholder preferences. Besides, while stock price changes reflect the view of the marginal investor, the voting outcome reflects the views of all investors, arguably resulting in a better opportunity to explore preferences of different types of investors. Other important difference is that shareholders in these firms were not called to vote on the desirability of ESO expensing for *all* publicly traded firms, thus issues of competitive disadvantage may play a role - giving us a potentially richer setting.

predominant means to influence not only corporate decisions (e.g. the no-confidence vote against Disney's CEO, Michael Eisner in 2004) but also policy reform debates (Bebchuk, 2003a).<sup>4</sup>

Finally, our work contributes to the literature on unions. Economists have long investigated the overall effects of unions on the economy (for a summary, see Freeman, 2005), while studies in finance and accounting have focused on the effects of unions' presence on the incentives to manage earnings (e.g. De Angelo and De Angelo, 1991; De Angelo et al., 1994; D'Souza et al., 2001), on managerial pay (Di Nardo et al., 1997), on information asymmetry (Hilary, 2005), etc. Little work has been devoted to the analysis of the role that unions play when wearing the shareholders' hat (Schwab and Thomas, 1998). Our paper starts to fill this gap by analyzing an initiative – the ESO expensing – of great visibility in the business community.

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, analyzes the characteristics of the targeted firms and discussed the motives of the shareholder proponents. Section 4 outlines our methodology and defines the dependent and independent variables, while Section 5 presents the results and Section 6 concludes.

## **2. Hypotheses Development**

The increase in the level of executive compensation during the 1990s, mostly fueled by large grants of ESO, has attracted strong criticism from investors, concerned with the growing

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<sup>4</sup> An example is the controversial S.E.C. proposed rule that would require firms to include in the proxy materials shareholder-nominated candidates to the Board of Directors (Bebchuk, 2003b). Under pressure from business lobbyists, the S.E.C. has essentially abandoned the proposal. In response, shareholder activists have submitted at the 2005 annual meetings a number of proposals requesting firms to give shareholders the right to nominate their own directors. Faced with the S.E.C. decisions that such proposals are not allowed on the proxy ballot (under Rule 14a-8), shareholders have submitted a different type of proposals requesting firms to implement a majority-voting election system for their Boards. Some of these proposals have been approved and implemented at some firms, while other firms (e.g. Pfizer) have voluntarily chosen to adopt a majority-voting system. As a result of this initiative, the policy debate on elections of Board of Directors is still alive.

disconnect between executives' pay and firms' performance, the increase in dilution (exacerbated by the widespread use of ESO at the non-executive level), and the distorted incentives provided by option grants.<sup>5</sup>

There is a general belief among the public that excessive option-based compensation is 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 of this argument is that expensing ESO will reduce the use of option-based compensation.

Voting shareholders may expect ESO expensing to result in lower option-based compensation for two main reasons. First, if managers and directors fixate on earnings—because of concerns with the effect on bonuses and/or because they believe markets are fixated on earnings—they may be expected to reduce stock option awards in an attempt to minimize the impact on earnings. Second, managers may also be concerned with the higher visibility and transparency of their compensation triggered by a recognition regime (Guay et al., 2003).<sup>6</sup>

The above arguments may have given voting shareholders reason to believe that, under an expensing regime, managers and Boards will reduce option-based compensation,<sup>7</sup> leading to the following hypothesis:

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<sup>5</sup> A number of studies document a strong association between option compensation and earnings management (Bergstresser and Philippon, 2005), accounting restatements (Burns and Kedia, 2004; Efendi et al., 2004), accounting fraud (Johnson et al., 2003; Erickson et al., 2004) and shareholder litigation (Peng and Roell, 2004). Further, previous research has also documented opportunistic behavior in the timing of CEO option grants and repricings (Yermack, 1997; Ferri, 2004), 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, 2003).

<sup>6</sup> 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., 2003b) or recognized (Johnston-Wilson, 2003) under SFAS 123, and (iii) have poorer voluntary disclosure of compensation practices in the proxy statements (Laksmana, 2005).

<sup>7</sup> While the effect of *mandatory* ESO expensing on option-based compensation practices cannot be empirically documented yet, preliminary evidence suggests that firms *voluntarily* expensing ESO in 2002 have been reducing the use of option-based compensation (Seethamraju and Zach, 2003) and that most of the other firms have been revising their stock option plans (e.g. decrease size of grants, restrict eligibility, etc.) in preparation for mandatory option expensing (Employee Ownership Report, 2004).

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

Some voting shareholders may fear that ESO expensing will cause a drop in stock price proportional to the magnitude of the expense. Two arguments may induce this *belief*.

First, ESO expensing may reveal to the market the extent of the option compensation cost—the underlying assumption being that currently investors are not able to fully recognize this amount from the financial footnotes, either because they are fixated on the earnings number or because information disclosed in footnotes is less reliable/visible (Bodie et al., 2003) and more costly to process (Barth et al., 2003) than information recognized in the income statement. Recent experimental work also suggests that misstatements in disclosed amounts are less likely to be corrected by auditors, i.e. the very fact of disclosing rather than recognizing option expense may reduce its reliability (Libby et al. 2005). While a number of papers have documented that SFAS No.123 pro forma disclosures are value relevant (Aboody, 1996a; Aboody et al., 2004), these findings do not imply that ESOs are fully and correctly priced and, thus, do not exclude the possibility of a differential impact of recognition versus disclosure of option-based compensation. Indeed, Espahbodi et al. (2002) analyze returns around announcements by FASB during its deliberations of SFAS No.123 relating to recognition versus disclosure of stock-based compensation expense and conclude that disclosure is not a substitute for recognition. It follows that, to the extent that investors place more weight on recognized versus disclosed amounts (Aboody, 1996b; Davis-Friday et al., 1999), recognizing the ESO expense could trigger a price decline proportional to its magnitude.

A second argument is that, even without any differential valuation effect between recognition and disclosure, ESO expensing can create real economic costs to the firm if it affects the terms of

current contracts or requires their renegotiation (Watts and Zimmermann, 1990; Guay et al., 2003).

In summary, under either argument ESO expensing is expected to trigger 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 over time votes against management have become more frequent and 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, surveys suggest that the vast majority of institutional investors are in favor (CalPERS, 2002; McKinsey & Co., 2002), though there is anecdotal evidence of remarkable exceptions, such as Fidelity (Dow Jones Newswires, 2003). Also, 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). As a result, we make no prediction on the sign of the overall relation between institutional ownership and votes FOR.

However, we hypothesize that institutional investors more concerned with *short-term reported earnings*—and thus, with the negative earnings impact from expensing ESO—will be more likely to vote against the proposal,<sup>8</sup> while institutions more concerned with *long-term value* benefits from a reduction in excessive option usage—and, perhaps, enhanced transparency of accounting numbers—will be more likely to vote in favor:

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<sup>8</sup> Bushee (2001) finds that institutions with short investment horizons myopically price firms, overweighting short-term earnings potential and underweighting long-term earnings potential.

*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 actual or potential business dealings with the firm will be 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 are more likely to vote in favor of ESO expensing in an attempt to discipline the use option-based compensation (Almazan et al. 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 oppose 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.*<sup>9</sup>

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<sup>9</sup> This prediction is in stark contrast to Aboody et al. (2003a), who hypothesize and find a positive relation between insiders' ownership and voluntary adoption of ESO expensing policy. The reason for the different prediction is that our sample is characterized by firms where management resisted change by opposing shareholders' calls for ESO expensing, whereas their sample comprises firms where management voluntarily decided to expense ESO. Noticeably, as shown in Sec.5.1, firms in our sample are characterized by higher options' usage relative to the sample of voluntary adopters analyzed by Aboody et al. (2003a), consistent with higher costs to management from ESO expensing.

A more interesting question is whether insiders' ownership affects *non-insiders'* votes. In this respect, we predict that non-insider shareholders may believe that high insider ownership will magnify the distorted incentives 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 the Economics of Shareholder Voting**

#### ***3.1 Sample Selection, Incentives of Proponents and Characteristics of Targeted Firms***

We identified 153 shareholder proposals for ESO expensing submitted during the 2003 and 2004 proxy seasons, 107 of which were voted upon at the annual meeting (Table 1, Panel A). About 90% of the proposals were sponsored by union funds (Table 1, Panel B). Spurred by the recent governance scandals and the growing gap between CEO pay and average employee compensation, unions have been increasingly active on a number of governance and compensation issues (e.g. prohibit consulting work from auditors, adopt performance-based options, Board independence, etc.).<sup>10</sup>

The peculiar nature of the proponent opens the possibility of a sample selection bias. To understand the characteristics of the targeted firms and any associated bias, one first needs to analyze the objectives of the union funds and link them to the targeting criteria. The unions launched this 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.<sup>11</sup> Both these objectives are more likely to be

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<sup>10</sup> For a general discussion of the role of unions as shareholders and its interaction with the traditional unions' role, see Schwab and Thomas (1998).

<sup>11</sup> 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

achieved if the proposals receive higher *voting support*. From this perspective, it might seem convenient to target, for example, firms where the earnings impact from ESO expensing is minimal.<sup>12</sup> Similarly, it may be attractive to target firms with poor performance and questionable compensation practices (e.g. lavish use of option-based compensation). However, in both cases, FASB would likely not consider such samples representative of the views of the investment community at large, de facto neutralizing the potential *impact* of the initiative. Hence, it may make more sense to target a more representative sample. Apparently, this was the approach followed by the unions,<sup>13</sup> except that they chose to target *large and visible* firms to obtain stronger press coverage (and, thus, maximize the impact of their initiative).

However, the union funds' targeting criteria may well have been driven by their own political agenda at specific firms.<sup>14</sup> For example, targeted firms may have been chosen based on their unionized status or the outcome of current negotiations with management. To account for all these possibilities, we analyze: i) a number of variables identified in previous studies (Karpoff et al., 1996; Johnson and Shackell, 1997; Bizjak and Marquette, 1998) as general determinants of the likelihood of being targeted by a shareholder proposal ( executives' ownership, EXECOWN; institutional ownership, INSTOWN; total assets, LNSIZE; MARKET-TO-BOOK ratio; 3-year stock returns, RETURNS; LEVERAGE; the percentage of executives sitting on the Board, EXECONBOARD; a dummy for HITECH industry); ii) two proposal-specific variables - the

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(UBCJA, LIUNA, IBEW, IBT, CPF, SMWIA, UA – see Table 1, Panel B) that jointly promoted the ESO expensing initiative.

<sup>12</sup> Shareholders in these firms may favor option expensing because they favor a more transparent reporting or in the hope that the relative valuation of their firms may benefit once other option-heavy firms start to expense ESO.

<sup>13</sup> “*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). However, UBCJA representatives told us that the second round of proposals in 2004 was more directed at firms with large ESO expense. Some firms were targeted in both years (see Table 1, Panel B).

<sup>14</sup> For example, CalPERS' no-vote campaign against directors at 2,400 companies was criticized as driven by its pro-labor agenda. “*Union-dominated CalPERS withheld support for directors at Safeway on the heels of a bruising*

degree of options' usage, DILUTION (or alternatively, CEO option holdings, OPTCEO) and the magnitude of the option expense (OPTEXPENSE); and iii) a proponent-specific variable, the percentage of unionized employees (UNION).

Table 2, Panel A, shows that the 153 firms targeted were indeed distributed across multiple industries. However, there is also an over-representation of utilities, a sector traditionally characterized by high degree of unionization.<sup>15</sup> 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 sample 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 the firms in the S&P 500 index (excluding targeted firms and voluntary expensers). Univariate tests suggest that firms targeted by the ESO expensing proposals are still significantly larger. They also 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.<sup>16</sup> In particular, while they have a higher percentage of unionized employees, the difference is not significant.

In a multivariate setting, the probit regression in Table 2, Panel C (col. 1 and 2), shows that 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

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*supermarket strike...leading some to conclude that the attack was payback for Safeway's tough strike stance.*" (Business Week, June 7, 2004)

<sup>15</sup> A chi-square test rejects the null hypothesis that the industry composition of the sample firms is equal to that of all Compustat firms. This result is driven by the over-representation of firms in the utility sector and the lumber, wood, paper and printing industry.

<sup>16</sup> Untabulated tests show similar results for the sub-sample of 107 targeted firms where the proposal was ultimately voted upon.

executives sitting on the Board<sup>17</sup> (relative to the other firms in the S&P 500). 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 targeted firms avoiding the vote by agreeing to expense ESO (see Table 1, Panel A) are larger. The results in col. 3 will be used as first-step for the two-step Heckman employed to control for selectivity bias in the analysis of the determinants of the voting outcome in Sec.4 and 5.<sup>18</sup>

### ***3.2 Effects of the ESO Expensing Proposal: Voting Outcome and Other Consequences***

Under the current legal regime, shareholder proposals are typically non-binding, raising the question of their real economic consequences. Assessing these consequences is a complex task, because of the numerous potential effects on targeted firms before, during and after the annual meeting where the vote takes place (Karpoff, 2001).

*Before the vote*, a measure of the economic impact of a proposal is the fraction of targeted firms agreeing to adopt it—usually an indication that management is concerned with the consequences of an undesired voting outcome. In our sample, about 25% of the firms targeted in 2003 agreed to expense before the annual meeting (Table 1, Panel A). Some of the other firms tried to exclude the proposal from the proxy by challenging its validity with the S.E.C., or engaged in costly campaigns to promote a vote against the proposal – Intel being the most egregious example.<sup>19</sup>

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<sup>17</sup> More independent Boards may be targeted because more likely to implement the proposal if adopted. Also, outside Board members are likely to sit on other Boards, paving the way for spillover effects to other firms.

<sup>18</sup> 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.

<sup>19</sup> 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](http://www.sec.gov), Proxy Material filed by Intel Corp).

Notwithstanding companies' efforts to oppose the ESO expensing proposal, the degree of support *at the annual meeting* was one of the highest ever received by a shareholder proposal (Georgeson Shareholder). As shown in Table 1, Panel B, on average, there were 47% votes FOR, 49.6% AGAINST and 3.4% ABSTAINED, resulting in 51 out of 107 proposals being approved. In contrast, other compensation-related shareholder proposals submitted to the same firms during the same period averaged less than 20% votes FOR. Even more tellingly, votes FOR as a % of all *non-insider* votes averaged 56% and would have yielded a majority vote at 77 firms.

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. Shareholders' support increased in 2004, when 62% of the proposals were approved (compared to 42% in 2003).<sup>20</sup> 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.

In addition to the publicity effect, a favorable voting outcome also puts pressure on the firm to implement the proposal *after the vote*, even if the proposal is non-binding. While historically Boards have largely ignored majority votes on shareholder proposals, in recent years they have become more responsive (Ertimur et al., 2005), possibly due to higher scrutiny by governance ratings agencies measuring "responsiveness to shareholders" (e.g. The Corporate Library) and concerns with regulatory action.<sup>21</sup> In our sample, 23% of the firms with a majority vote in the 2003 proxy season—that is, before the release of FASB Exposure Draft—adopted option

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<sup>20</sup> 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 disclosure of proxy votes by mutual funds may have resulted in more votes for option expensing.

expensing, a figure in line with other shareholder proposals over the period 1998-2002 (Del Guercio et al., 2004). Even in firms where the proposal was not adopted or did not pass, the voting results may have prompted changes in option compensation practices. For example, Intel introduced a new stock option plan requiring shareholder approval every year (WSJ, 2004), while Siebel Systems entirely redesigned its compensation program with the blessing of CalPERS (WSJ, 2005).

Overall, our analysis suggests that the ESO expensing proposal—even if non-binding—fared well in terms of the typical measures of success for shareholder proposals.<sup>22</sup>

### ***3.3 Incentives of Voting Shareholders***

Black (1990) develops an analytical model where voting shareholders tradeoff the cost of becoming informed with the benefits of making an informed decision—which, in turn, depend on the likelihood of influencing the voting outcome and the expected increase in firm value as a result of the vote. The model also predicts a higher likelihood of an informed vote when the proposal either creates positive spillover effects on other firms in the shareholder portfolio (higher benefits) or is presented at many of these other firms (resulting in lower costs per proposal). As a result, proposals aimed at reforming structural (rather than firm-specific) issues are more likely to be successful.

A number of characteristics of the ESO expensing proposal suggest that voting shareholders expected higher benefits and incurred lower costs from getting informed, relative to most other shareholder proposals.

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<sup>21</sup> S.E.C Chairman W. Donaldson presented a plan under which a pattern of ignoring significant shareholder support of resolutions could trigger shareholder access to the Board nominating process (Reuters, 2003).

<sup>22</sup> Another potential effect of shareholder proposals is to influence non-targeted firms. Conceivably, the threat of a shareholder vote may have played a role in some firms' decision to voluntarily adopt ESO expensing in 2002-2003.

With respect to the costs, (i) the extensive media coverage of this topic (ii) the high percentage of sophisticated and presumably already informed institutional investors in targeted firms (Table 1, Panel D), and (iii) the high probability that many institutions held shares in several of the targeted firms (given that 82% of the sample firms were in the S&P 500), resulted in a relatively low cost of getting informed for individual investors and probably no cost for institutional investors.

With respects to the benefits, we argue that in most companies shareholders' perception of the likelihood of influencing the voting outcome was substantial, for two reasons: (i) targeted firms were characterized by high institutional ownership (65%) *and* the pro-expensing position of most of these institutions and their representatives (e.g. TIAA-CREF, Council for Institutional Investors and Institutional Shareholder Services) was well known *before* the proxy season; (ii) 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. Also, the potential for positive spillover effects—a characteristic particularly attractive to index funds—was likely to be higher than for any other shareholder proposal, for two reasons: (i) the high press coverage put pressure on management and Boards even in non-targeted firms; (ii) more importantly, a majority vote potentially could have affected FASB decision to mandate the expensing of ESO for *all* publicly traded firms and thus (all else being equal) increase exponentially the expected benefit (e.g. more disciplined use of options).<sup>23</sup>

The above analysis suggests that the voting outcome of the ESO expensing proposal is an economically relevant phenomenon and, as such, it may be informative of shareholders' views on ESO expensing.

#### 4. Research Design and Variable Definitions

To test our hypotheses we use 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.3.2 (see Table 2, Panel C, col.3) and the second step is the following OLS regression:

$$\% \text{ Votes FOR Option Expensing} = f(\text{Excessive Option Compensation, Expected Earnings Impact from Expensing Options, \% Votes controlled by Institutions, \% Votes controlled by Insiders, Inverse Mills Ratio, Control Variables}) \quad (1)$$

##### 4.1 Dependent Variable: % Votes FOR Option Expensing

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

$$VOTESFOR = \# \text{ Votes For} / (\# \text{ Votes For} + \# \text{ Votes Against})$$

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:  $VOTES = \text{Log}(VOTESFOR / (1 - VOTESFOR))$ .<sup>24</sup>

##### 4.2 Main Independent Variables

Below we describe the variables used to test our Hypotheses 1-4. Appendix 3 provides more details on their computation and the data sources used.

###### a) *Excessive 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

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<sup>23</sup> “Votes could have influence well beyond the boardroom...FASB and Congress will be watching the battles closely for sign that popular support for expensing – especially among high-tech investors – has reached the high-water mark” (Business Week, May 27, 2003).

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. 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 firms – i.e. firms of similar size competing in the same industry.

***b) Expected Earnings Impact from Expensing Options***

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

- *Magnitude of Option Expense [OPTEXPENSE]*: a naturally proxy for shareholders’ concern about negative consequences from expensing is the magnitude of the disclosed option expense. As in Aboody et al. (2003a), we scale it by the year-end market value of equity.
- *Profit Loss Threshold [PROFTHRESH]*: voting shareholders may be concerned with the effect of expensing on certain earnings benchmarks. Previous literature has documented negative liquidity effects associated with reporting losses (Hwang et al., 1996; Ertimur, 2003). Thus, shareholders may fear a change from profit to loss will affect price. We construct a *profit/loss threshold* dummy equal to 1 when option 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.

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<sup>24</sup> All the results presented in this study are unchanged when we use VOTESFOR instead of its logit transformation, as well as when VOTESFOR is redefined as percentage of *all* votes cast, *including* abstention votes.

Then, to capture the characteristics of different types of institutional investors and test 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, as proxied for by measures 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].

#### **4.3 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,<sup>25</sup> 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., 2003a) 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 SFAS No.123). Smaller firms, on the other hand, may be more concerned about an excessive 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). Consistent with this evidence, Aboody et al. (2003a) predict and find that firms with higher debt-equity ratios are more likely to voluntarily expense ESO, since ESO expense recognition results in lower debt-equity

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<sup>25</sup> 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.

ratios.<sup>26</sup> By the same token, we predict that in firms with higher leverage, shareholders will be more likely to vote in favor of ESO expensing.

- *Interest Coverage [INTERESTCOVG]*: while recognition of ESO expense reduces leverage, it also has the effect of reducing the interest coverage ratio, and, thus, raises the likelihood of violating certain debt covenants. Since more leveraged firms tend to have lower interest coverage ratio, from this perspective expensing ESO may hurt firms with higher leverage. 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.<sup>27</sup> Accordingly, we construct the following three variables:

- *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.
- *Other Shareholder Proposals on Executive Compensation [OTHERPROPOSAL]*: we construct a dummy equal to 1 if other shareholder proposals related to executive compensation were submitted for a vote at the same annual meeting, 0 otherwise. While the evidence on the effectiveness of these proposals on compensation practices is mixed

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<sup>26</sup> 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.

<sup>27</sup> 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

(Johnson and Shackell, 1997; Thomas and Martin, 1999), their presence can be interpreted as an indication of shareholders' dissatisfaction with executive compensation practices. Thus, we predict a positive relation between this dummy and votes in favor of ESO expensing.

- *Equity-based Compensation Plans Adopted Without Shareholder Approval*

*[NONAPPROVEEQUITY]*: recent SEC rules require firms to obtain shareholder approval and provide disclosure for all their equity compensation plans [SEC (2003), SEC (2002)]. We calculate the fraction of total options outstanding 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 have started to voluntarily recognize ESO expense in their income statement. A common argument against ESO expensing (see Appendix 2) is that it would put the firm at a competitive disadvantage relative to its peers. This argument would lead to predict a positive relation between fraction of 'voluntarily expensing' firms in the same industry and voting support for expensing proposals. However, Aboody et al. (2003a) 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.

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Fried (2004) provide an in-depth discussion of the limitations of these indirect mechanisms and summarize the evidence on the (limited) effectiveness of Compensation Committees in protecting shareholders' interests.

- *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 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 result in about 48% of the firms classified as having CEO excessive 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. (2003a)—0.59% (0.18%)—suggesting higher option usage in firms targeted by 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), 36% of them were targeted by at least one other proposal dealing with executive compensation matters (OTHERPROPOSAL),<sup>28</sup> and over 55% reported the existence of non-approved equity-based compensation plans (covering on average, 23% of the options outstanding). 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 4 reports the Pearson correlations among the variables included in our main tests. Consistent with prior studies on shareholder voting, ownership composition appears the main determinant of the voting outcome, with VOTESFOR showing strong positive (negative) correlation with institutional (insiders') ownership. Also, VOTESFOR is also significantly and positively correlated with EXCESSOPTCEO and with a number of control variables (SIZE, LEVERAGE and NONAPPROVEQUITY), consistent with our predictions, 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 a two-step Heckman procedure, with the following model for the second step:

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<sup>28</sup> These proposals were: replacement of conventional options with indexed or performance-based options (25 firms) or performance-based restricted stock (5 firms), prohibition of issuance of stock option grants (1 firm), exclusion of net pension income from net income in determining executive bonuses (3 firms), adoption of new guidelines to determine executive compensation (2 firms), review and better disclosure of compensation practices (2 firms), requirement that executives retain 75% of equity awards (3 firms), requirement of shareholder approval for severance agreements of senior executives (3 firms), for certain supplemental executive retirement benefits (2 firms) or for all equity compensation plans (1 firm). Some firms were targeted by more than one proposal.

$$\begin{aligned}
VOTES_i = & \beta_0 + \beta_1 * EXCESSOPTCEO_i + \beta_2 * EARNINGSIMPACT + \beta_3 * INSIDEOWN_i \\
& + \beta_4 * INSTOWN_i + \beta_5 * LAMBDA_i + \beta_n * CONTROLS_i + \varepsilon_i
\end{aligned}
\tag{2}$$

with *EARNINGSIMPACT* alternatively defined as *OPTEXPENSE* or *PROFTHRESH* and with *LAMBDA* being the inverse Mills ratio obtained from the first-stage probit regression in Table 2, Panel C, column 3.<sup>29</sup>

The results in Table 5 (Panel A, columns 1 and 2) provide significant support for some of our hypotheses. 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.

In columns 3 and 4 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, *EXCESSOPTNONCEO* is not related to the voting outcome. One interpretation is 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*.

Results for the control variables are generally consistent across the four columns in Table 5 (Panel A). 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 and worse stock performance, while the coefficient on

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<sup>29</sup> The results in the rest of the paper are unchanged when the inverse Mills ratio is obtained instead from the probit regression in Table 2, panel C, column 4.

size, though positive, is only significant in two of the four columns. However, none of the controls related to “governance” and “industry” characteristics are significant.

To investigate differences across institutional investors (H3a and H3b), in Table 5 (Panel B) we repeat the analysis after splitting them first into LONGTERM and TRANSIENT investors (columns 1 and 2), and then into ACTIVE and PASSIVE (columns 3 and 4). As predicted, ‘long-term value’ oriented institutions are positively and significantly associated with votes in favor of expensing, but we do not find that ‘short-term earnings’ oriented 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,<sup>30</sup> while the coefficient on PASSIVE is insignificant.

To further our understanding of the relation between voting outcome and types of institutional investors we combine the LONGTERM vs. TRANSIENT classification with the ACTIVE vs PASSIVE classification, resulting in four groups of institutional investors (active/longterm, active/transient, passive/longterm, passive/transient). Untabulated tests reveal that the only group with a positive and significant coefficient is the active/transient group. Combined, the above results suggest that: i) PASSIVE institutions (banks and insurance companies), on average, do not support the ESO expensing proposal, consistent with at least some of them voting with management due to actual or potential conflicts of interest; ii) among

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<sup>30</sup> 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. For example, in 2001 Fidelity earned more than half of its revenues by providing fee-based services to companies at which it voted proxies on behalf of fund investors. This problem has prompted the S.E.C. in 2003 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 (at least in 2004) abstained from voting on ESO expensing proposals, possibly to ‘please’ the high-tech business community in California – an indication of more complex conflicts of interest than the ACTIVE/PASSIVE split may suggest.

the ACTIVE institutions (investment companies, independent investment advisors, etc.), somewhat surprisingly, only TRANSIENT investors support the expensing proposal. A potential interpretation for the latter results is that the cost of voting against management is higher for ‘long-term oriented’ institutions— i.e. keeping good relations with management is more important the longer the investment horizon.

Finally, to provide evidence on how the level of insiders’ ownership affects non-insider votes (Hypothesis 4b), in Table 5, Panel C, we redefine VOTESFOR as a fraction of all votes cast by *non-insiders*, implicitly assuming that all insiders voted against.<sup>31</sup> This assumption is supported by the high correlation between INSIDEOWN and VOTESFOR (Table 4) and allows us to focus on the determinants of the votes really “in play”. A comparison with Table 5, Panel A, highlights a number of interesting findings. First, the coefficient on INSIDEOWN is now positive and significant, suggesting that *non-insiders* are more likely to vote for ESO expensing when insiders’ ownership – possibly viewed as a proxy for rent extraction opportunities - is higher, consistent with H4b. Second, OPTEXPENSE, while still negative, is no longer significant, suggesting a somewhat less important role of the expected earnings impact. Third, there is a negative association between voting outcome and VOLUNTEXP. If voting firms have higher option expense than their peers voluntarily expensing ESO (see Sec.5.1), this finding may reflect lower support for ESO expensing in firms with higher *relative* expected earnings impact. Overall, the general consistency between Panel A and Panel C strengthens our confidence in the results.<sup>32</sup>

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<sup>31</sup> The dependent variable is therefore  $NONINSIDER\_VOTES = \log [NONINSVOTESFOR / (1 - NONINSVOTESFOR)]$ , where  $NONINSVOTESFOR = \text{Votes For} / (\text{Votes For} + \text{Votes Against} - \text{Votes Insiders})$ .

### 5.2.2 Robustness Tests

In all the analyses above the LAMBDA is not significant, suggesting that selection bias does not appear to be a concern. Indeed, when we use a simple OLS regression (clustering by firm to account for cases with proposals in both 2003 and 2004) instead of the two-step Heckman mode, as shown in Table 5, Panel D, the results mirror closely those reported in Table 5, Panel A.

Untabulated tests reveal that all the other findings (reported in Table 5, Panels B and C) are also unchanged. In all these OLS regressions the independent variables have a Variance Inflation Factor (VIF) score below 3, alleviating concerns of multi-collinearity.

We also performed some robustness tests on the main variables. In particular, we redefined OPTEXPENSE based on the 3-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<sup>33</sup>; ii) to allow for industry classifications alternative to Core and Guay (1999), such as Fama and French (1997) and SIC 2-digits; and iii) to include options held by all the Named Executive Officers (i.e. top 5 executives) as opposed to the CEO only. Finally, we redefined ‘long-term oriented’ (‘short-term oriented’) institutional ownership as the cumulative ownership by institutional blockholders (non-blockholders). The results in Table 5 are not affected by these alternative specifications.<sup>34</sup>

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<sup>32</sup> In untabulated tests, we also replicate the analysis in Panel B (institutional investors’ types) after re-defining VOTESFOR as a fraction of all votes cast by non-insiders. Our previous inferences about the relation between voting outcome and types of institutional ownership are essentially unaffected.

<sup>33</sup> 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 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.

<sup>34</sup> We also performed (untabulated) sensitivity tests on the control variables. The main results are essentially unchanged when we define: i) HITECH based on the classification in Francis and Schipper (1999) rather than Murphy (2003); ii) VOLUNTEXP based on the Core & Guay (1999) or Fama and French (1997) industry classification rather than the 4-digit SIC Code; iii) VOLUNTEXP as a dummy equal to 1 if at least one firm in the same industry has announced the intention to expense ESO; iv) ADJRET as returns relative to the industry mean (rather than relative to a value-weighted industry average); v) OTHERPROPOSAL as a dummy equal to 1 if there is

## 6. Conclusions

In the proxy season of 2003, for the first time, the S.E.C. allowed shareholder proposals on an accounting matter. Shareholders were allowed to vote on the accounting treatment for ESO. In this context, over the 2003 and 2004 proxy seasons shareholder activists targeted more than 150 firms with a proposal to expense ESO. In this study we describe the characteristics of targeted firms and provide evidence on shareholders' views on ESO expensing by examining the voting outcome of these proposals at a sample of 107 firms.

Firms targeted by shareholder activists are larger than the average public firm, and tend to have a larger fraction of options outstanding relative to total options, despite a lower impact of option expensing. As for the voting outcome, we hypothesize that voting shareholders trade-off the potential costs associated with the earnings impact for the benefits of a more moderate use of ESO (expected as a result of expensing). Consistent with this prediction, we find that votes in favor of ESO expensing are positively related to the perceived extent of excessive option compensation and negatively related to the expected earnings impact of expensing ESO. Not surprisingly, we document a strong negative association between votes for ESO expensing and insider holdings, but non-insider shareholders are more likely to vote for expensing in firms with larger insiders' ownership. We also find evidence of support for ESO expensing across different types of institutional investors (classified based on the horizon of their investments and their potential conflicts of interest), except for institutional investors with potential business dealings with their portfolio firms. Finally, support for ESO expensing appears to be higher in larger firms, in firms characterized by lower stock returns, and in firms with higher leverage and

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at least one other shareholder proposal dealing with *either* executive compensation *or* other corporate governance issues (poison pills, staggered Boards, etc.). Under some of these specifications, LNSIZE loses significance while the positive association between HITECH and votes in favor of expensing becomes significant.

interest coverage ratios, consistent with visibility, past performance and contracting costs playing an important role in shareholders' voting decisions.

Besides contributing to the accounting literature on ESO expensing and the political process of standard setting, and to the growing research on shareholder activism, our findings may be of interest to managers, shareholder activists, proxy voting services, regulators and standard setters.

## Appendix 1: The ‘Race’ 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 3-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 (Share-Based Payment, an Amendment of FASB Statements No. 123 and 95) 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 FAS 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
<p><b>Enhance transparency by reporting accurately the company's operational earnings, including executive compensation costs.</b> A recent report issued by Standard &amp; Poor's indicated that expensing stock options would have lowered operating earnings at companies by as much as ten percent.</p>	<p><b>All the cost is reflected in diluted EPS, expensing would be misleading.</b> 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."</p> <p><b>There is already complete information to assess the impact of stock options on the value of the company.</b> 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.</p> <p><b>The Black and Scholes model used to estimate the value of employee stock options is inappropriate.</b> 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.</p> <p><b>The company provides voluntary disclosures</b> to help investors fully understand the nature and impact of the stock option programs</p>
<p><b>Deter excessive use of options for compensation</b></p>	<p><b>The company has always made a moderate use of options</b></p> <p><b>Compensation abuse should be stopped by other corporate governance mechanisms.</b> 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.</p>
<p><b>Other companies are expensing</b> 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.</p>	<p><b>The company should await development of rules by FASB/SEC</b> 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.</p> <p><b>The "Intrinsic Value" Method is the most widely used and investors have a need for financial statements that facilitate comparisons between companies.</b> The firm should follow the most widely used industry practice and should avoid adopting a practice that would place it at a competitive disadvantage.</p>
<p><b>Deter strategies promoting short term stock price rather than long term corporate value</b></p>	<p><b>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</b></p>

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

### Appendix 3: Definition of Variables

	Expected relation to VOTES
<b>DEPENDENT VARIABLE</b>	
VOTES= Logit transformation of: Votes For / (Votes For + Votes Against). Source: 10Q filed after the annual meeting.	
<b>MAIN EXPLANATORY VARIABLES</b>	
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. <sup>35</sup>	Positive
OPTEXPENSE= Option expense reported under SFAS No.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 No.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. <sup>36</sup> 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

<sup>35</sup> 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 3-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).

<sup>36</sup> 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 C). Note that in this case, we also re-scale accordingly the percentage ownership by institutions.

### Appendix 3: Definition of Variables (Continuation)

	<b>Expected relation to VOTES</b>
<i>LONGTERM, TRANSIENT</i> = % of shares held by, respectively ‘long-term’ (‘dedicated’ and ‘quasi-indexers’) and ‘transient’ institutional investors, defined as in Bushee (1998). Sources: classification as of the end of 2002 provided by Bushee and Thomson Financial.	Positive (Longterm) Negative (Transient)
<i>ACTIVE</i> = 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.).	Positive
<i>PASSIVE</i> = Percentage of shares held by institutional investors classified by Thomson Financial as Type 1 (Banks) or Type 2 (Insurance companies).	Negative
<b>CONTROL VARIABLES</b>	
<i>SIZE</i> = Total assets of the firm measured in billions of US dollars (Compustat DATA6).	Positive
<i>ADJRET</i> = Industry-adjusted stock returns over the 3-year period leading to the month of shareholders’ vote at the annual meeting. 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
<i>LEVERAGE</i> = Ratio of total debt to total assets $[(DATA9 + DATA 34)/DATA6]$ in Compustat].	Positive
<i>INTERESTCOVG</i> = Dummy variable equal to 1 if the firm’s interest coverage ratio (EBIT/interest expense) 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, the ratio is not defined. For these firms, we assume the ratio is greater than the highest ratio in the sample and then construct the INTERESTCOVG dummy.	Positive
<i>CONFLICT</i> = Dummy variable equal to 1 if a conflict of interest on the Compensation Committee is disclosed in the Proxy Statement, and 0 otherwise. <sup>37</sup>	Positive
<i>OTHERPROPOSAL</i> = Dummy variable equal to 1 if the proxy statement contained other shareholder proposals concerning executive compensation issues, 0 otherwise.	Positive
<i>NONAPPROVEEQUITY</i> = % of total options outstanding granted under equity compensation plans not submitted to shareholders’ approval. Source: Proxy Statements.	Positive
<i>VOLUNTEXP</i> = % 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
<i>HITECH</i> = 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

<sup>37</sup> 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**

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

**Notes:**

<sup>1</sup> Based on a list provided by UBCJA and complemented/cross-checked with various online sources.

<sup>2</sup> 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](http://www.thecorporatelibrary.com) and [www.georgesonshareholder.com](http://www.georgesonshareholder.com)).

<sup>3</sup> 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 <sup>1</sup>	Voting Turnout	Votes FOR as % of votes...			Passed <sup>2</sup>
				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 <sup>1</sup>	Voting Turnout	Votes for as % of votes...			Passed <sup>2</sup>
				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 <sup>1</sup>	Voting Turnout	Votes for as % of votes...			Passed <sup>2</sup>
				for + against + abstained	for + against	for + against - insider	
Guidant Corp	5/18/2004	UA	78.3%	62.4%	63.7%	66.1%	<b>Yes</b>
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%	<b>Yes</b>
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%	<b>Yes</b>
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%	<b>Yes</b>
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%	<b>Yes</b>
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%	<b>No</b>
Wells Fargo & Co/Mn	4/27/2004	Individual	74.1%	58.2%	59.8%	60.5%	Yes
Weyerhaeuser Co	4/13/2004	UBCJA	76.1%	62.4%	63.5%	66.8%	<b>Yes</b>
Yahoo! Inc	5/21/2004	UBCJA	72.2%	45.0%	45.9%	58.2%	No
<b>AVERAGE</b>			<b>72.5%</b>	<b>47.0%</b>	<b>48.6%</b>	<b>56.9%</b>	

**Notes:**

<sup>1</sup> 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

<sup>2</sup> 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
<b>Total</b>	<b>9820</b>	<b>100%</b>	<b>153</b>	<b>100%</b>

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 <sup>1</sup>			Targeted Sample	S&P 500 <sup>2</sup>		
<i>SIZE</i>	27086	5343	<b>21742</b>	<b>&lt;0.001</b>	27086	14609	<b>12477</b>	<b>0.009</b>
<i>LEVERAGE</i>	0.267	0.268	-0.001	0.936	0.267	0.243	0.024	0.167
<i>MARKET-TO-BOOK</i>	4.009	3.576	0.433	0.765	4.009	3.709	0.300	0.728
<i>RETURNS</i>	0.025	0.111	-0.086	0.108	0.025	0.050	-0.025	0.708
<i>INSTOWN</i>	0.647	0.252	<b>0.395</b>	<b>&lt;0.001</b>	0.647	0.683	<b>-0.036</b>	<b>0.022</b>
<i>EXECOWN</i>	0.006	0.009	<b>-0.003</b>	<b>0.010</b>	0.006	0.004	0.002	0.115
<i>OPTEXPENSE</i>	0.009	0.174	<b>-0.165</b>	<b>0.071</b>	0.009	0.013	<b>-0.004</b>	<b>0.088</b>
<i>PROFTHRESH</i>	0.052	0.058	-0.006	0.765	0.052	0.024	0.028	0.165
<i>EXECONBOARD</i>	0.281	0.303	-0.022	0.105	0.281	0.299	-0.018	0.275
<i>OPTCEO</i>	0.010	0.017	<b>-0.007</b>	<b>&lt;0.001</b>	0.010	0.009	0.001	0.838
<i>DILUTION</i>	0.110	0.123	-0.013	0.227	0.110	0.099	0.011	0.157
<i>UNION</i>	0.131				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<sup>2</sup>**

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

**Notes:**

<sup>1</sup> 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.

<sup>2</sup> 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.

*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.

*MARKET-TO-BOOK* = 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**  
**Descriptive Statistics**

Variable	N	Mean	Percentile				
			10th	25 <sup>th</sup>	50 <sup>th</sup>	75 <sup>th</sup>	90th
<i>VOTESFOR</i>	106	0.486	0.301	0.413	0.508	0.578	0.632
<i>EXCESSOPTCEO</i>	107	0.490	-0.908	-0.579	-0.049	0.803	2.279
<i>OPTEXPENSE</i>	107	0.011	0.001	0.003	0.004	0.010	0.031
<i>PROFTHRESH</i>	107	0.075	-	-	-	-	-
<i>INSIDEOWN</i>	107	0.105	0.008	0.018	0.040	0.149	0.308
<i>INSTOWN</i>	107	0.652	0.416	0.563	0.664	0.773	0.858
<i>LONGTERM</i>	107	0.383	0.239	0.321	0.378	0.458	0.523
<i>TRANSIENT</i>	107	0.250	0.120	0.184	0.252	0.307	0.371
<i>ACTIVE</i>	107	0.517	0.316	0.428	0.529	0.606	0.692
<i>PASSIVE</i>	107	0.146	0.085	0.100	0.148	0.183	0.210
<i>SIZE</i>	107	23.1	1.3	2.9	8.6	20.2	44.2
<i>ADJRET</i>	103	-0.213	-0.868	-0.591	-0.243	0.055	0.416
<i>LEVERAGE</i>	107	0.238	0.006	0.064	0.227	0.366	0.491
<i>INTERESTCOVG</i>	107	0.505	-	-	-	-	-
<i>CONFLICT</i>	107	0.196	-	-	-	-	-
<i>OTHERPROPOSAL</i>	107	0.364	-	-	-	-	-
<i>NONAPPROVEEQUITY</i>	107	0.130	0	0	0.012	0.195	0.418
<i>VOLUNTEXP</i>	107	0.043	0	0	0.019	0.071	0.111
<i>HITECH</i>	107	0.234	-	-	-	-	-

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

*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.

*OTHERPROPOSAL* = Dummy variable equal to 1 if the firm received another shareholder proposal dealing with executive compensation issues, 0 otherwise.

*NONAPPROVEEQUITY* = 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 Pearson Correlation Coefficients<sup>1</sup>**

	<i>VOTESFOR</i>	<i>EXCESSOPTCEO</i>	<i>OPTEXPENSE</i>	<i>PROFTHRESH</i>	<i>INSIDEOWN</i>	<i>INSTOWN</i>	<i>SIZE</i>	<i>ADJRET</i>	<i>LEVERAGE</i>	<i>INTERESTCOVG</i>	<i>CONFLICT</i>	<i>OTHERPROPOSAL</i>	<i>NONAPPROVEQUITY</i>	<i>VOLUNTEXP</i>
<i>EXCESSOPTCEO</i>	<b>0.252</b> 0.009													
<i>OPTEXPENSE</i>	0.057 0.564	<b>0.414</b> <0.001												
<i>PROFTHRESH</i>	-0.017 0.860	<b>0.274</b> 0.004	<b>0.536</b> <0.001											
<i>INSIDEOWN</i>	<b>-0.737</b> <0.001	-0.101 0.300	-0.038 0.697	-0.021 0.826										
<i>INSTOWN</i>	<b>0.594</b> <0.001	<b>0.305</b> 0.001	0.070 0.474	0.071 0.467	<b>-0.509</b> <0.001									
<i>SIZE</i>	<b>0.179</b> 0.066	-0.101 0.298	-0.128 0.189	-0.079 0.416	-0.148 0.127	-0.066 0.499								
<i>ADJRET</i>	-0.155 0.118	0.023 0.816	<b>-0.266</b> 0.006	-0.142 0.153	0.066 0.506	-0.015 0.884	-0.011 0.914							
<i>LEVERAGE</i>	<b>0.185</b> 0.058	-0.079 0.417	<b>-0.256</b> 0.008	<b>-0.178</b> 0.066	-0.141 0.149	0.076 0.439	0.015 0.877	-0.099 0.319						
<i>INTERESTCOVG</i>	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	<b>0.259</b> 0.008	<b>-0.505</b> <0.001					
<i>CONFLICT</i>	-0.082 0.401	-0.019 0.846	0.015 0.880	-0.051 0.602	0.117 0.228	-0.070 0.475	<b>0.312</b> 0.001	-0.002 0.984	-0.121 0.214	0.066 0.500				
<i>OTHERPROPOSAL</i>	0.097 0.324	-0.106 0.275	0.022 0.825	-0.068 0.489	<b>-0.182</b> 0.061	0.036 0.710	<b>0.271</b> 0.005	-0.024 0.808	<b>0.240</b> 0.013	-0.065 0.504	-0.032 0.744			
<i>NONAPPROVEQUITY</i>	<b>0.230</b> 0.018	0.142 0.144	<b>0.196</b> 0.043	0.065 0.505	<b>-0.189</b> 0.051	0.068 0.488	<b>0.225</b> 0.020	-0.047 0.639	<b>-0.214</b> 0.027	0.101 0.302	0.034 0.725	0.047 0.630		
<i>VOLUNTEXP</i>	-0.138 0.159	-0.132 0.176	<b>-0.250</b> 0.009	-0.128 0.189	0.066 0.498	-0.118 0.226	<b>0.136</b> 0.162	0.100 0.314	0.114 0.242	-0.116 0.235	<b>0.168</b> 0.083	-0.066 0.498	<b>-0.198</b> 0.041	
<i>HITECH</i>	0.068 0.489	<b>0.164</b> 0.091	<b>0.591</b> <0.001	<b>0.431</b> <0.001	-0.075 0.441	-0.044 0.650	-0.021 0.828	0.040 0.688	<b>-0.453</b> <0.001	<b>0.326</b> 0.001	-0.106 0.277	0.041 0.677	<b>0.280</b> 0.003	<b>-0.364</b> <0.001

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

<sup>1</sup> 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* = Percentage of shares held by insiders.

*INSTOWN* = Percentage of shares held by institutional investors.

*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 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.

*OTHERPROPOSAL* = Dummy variable equal to 1 if the firm received another shareholder proposal dealing with executive compensation issues, 0 otherwise.

*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 5**  
**Determinants of Shareholders' Votes on Option Expensing Proposals**  
**(Dependent Variable: VOTES)**

**Panel A: Second-Step Heckman Regression<sup>1</sup>**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Constant	<b>-1.030</b>	<b>-1.120</b>	<b>-1.049</b>	<b>-1.109</b>
<i>p-value</i>	0.001	<0.001	0.002	0.001
<i>EXCESSOPTCEO</i>	<b>0.048</b>	<b>0.042</b>	<b>0.048</b>	<b>0.042</b>
<i>p-value</i>	0.003	0.005	0.003	0.006
<i>EXCESSOPTNONCEO</i>			0.007	-0.003
<i>p-value</i>			0.799	0.897
<i>OPTEXPENSE</i>	<b>-5.304</b>		<b>-5.476</b>	
<i>p-value</i>	0.060		0.059	
<i>PROFTHRESH</i>		<b>-0.243</b>		<b>-0.242</b>
<i>p-value</i>		0.031		0.031
<i>INSIDEOWN</i>	<b>-2.069</b>	<b>-2.100</b>	<b>-2.072</b>	<b>-2.097</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>INSTOWN</i>	<b>0.905</b>	<b>0.886</b>	<b>0.901</b>	<b>0.889</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>LNSIZE</i>	0.037	<b>0.048</b>	0.037	<b>0.047</b>
<i>p-value</i>	0.122	0.033	0.123	0.035
<i>ADJRET</i>	<b>-0.150</b>	<b>-0.126</b>	<b>-0.151</b>	<b>-0.126</b>
<i>p-value</i>	0.006	0.011	0.006	0.011
<i>LEVERAGE</i>	<b>0.570</b>	<b>0.590</b>	<b>0.575</b>	<b>0.587</b>
<i>p-value</i>	0.007	0.005	0.007	0.005
<i>INTERESTCOVG</i>	<b>0.161</b>	<b>0.172</b>	<b>0.161</b>	<b>0.172</b>
<i>p-value</i>	0.020	0.012	0.020	0.012
<i>CONFLICT</i>	0.043	0.019	0.044	0.018
<i>p-value</i>	0.540	0.784	0.528	0.788
<i>OTHERPROPOSAL</i>	-0.058	-0.085	-0.058	-0.085
<i>p-value</i>	0.341	0.150	0.339	0.153
<i>NONAPPROVEQUITY</i>	0.068	0.028	0.070	0.028
<i>p-value</i>	0.660	0.853	0.652	0.855
<i>VOLUNTEXP</i>	-0.008	-0.008	-0.008	-0.008
<i>p-value</i>	0.185	0.179	0.185	0.181
<i>HITECH</i>	0.182	0.142	0.192	0.139
<i>p-value</i>	0.114	0.171	0.114	0.191
<i>MILLS LAMBDA</i>	0.017	0.018	0.031	0.011
<i>p-value</i>	0.911	0.909	0.849	0.947
<i>N</i>	99	99	99	99

**TABLE 5 (Continuation)**  
**Determinants of Shareholders' Votes on Option Expensing Proposals**  
**(Dependent Variable: VOTES)**

**Panel B: Second-Step Heckman Regression with Different Types of Institutional Investors<sup>1</sup>**

	Bushee's classification of Institutional Investors		Active vs. Passive Institutional Investors	
Constant	<b>-0.990</b>	<b>-1.091</b>	<b>-0.928</b>	<b>-1.011</b>
<i>p-value</i>	0.002	0.001	0.011	0.005
<i>EXCESSOPTCEO</i>	<b>0.047</b>	<b>0.041</b>	<b>0.050</b>	<b>0.043</b>
<i>p-value</i>	0.004	0.005	0.003	0.004
<i>OPTEXPENSE</i>	<b>-5.037</b>		<b>-5.120</b>	
<i>p-value</i>	0.074		0.073	
<i>PROFTHRESH</i>		<b>-0.259</b>		<b>-0.245</b>
<i>p-value</i>		0.021		0.031
<i>INSIDEOWN</i>	<b>-2.168</b>	<b>-2.199</b>	<b>-2.357</b>	<b>-2.378</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>LONGTERM</i>	<b>0.731</b>	<b>0.639</b>		
<i>p-value</i>	0.032	0.056		
<i>TRANSIENT</i>	<b>1.043</b>	<b>1.117</b>		
<i>p-value</i>	0.001	<0.001		
<i>ACTIVE</i>			<b>0.823</b>	<b>0.810</b>
<i>p-value</i>			<0.001	<0.001
<i>PASSIVE</i>			0.769	0.783
<i>p-value</i>			0.282	0.270
<i>LNSIZE</i>	<b>0.044</b>	<b>0.056</b>	0.038	<b>0.047</b>
<i>p-value</i>	0.090	0.019	0.192	0.089
<i>ADJRET</i>	<b>-0.148</b>	<b>-0.128</b>	<b>-0.147</b>	<b>-0.126</b>
<i>p-value</i>	0.007	0.010	0.009	0.014
<i>LEVERAGE</i>	<b>0.561</b>	<b>0.594</b>	<b>0.515</b>	<b>0.534</b>
<i>p-value</i>	0.009	0.005	0.017	0.013
<i>INTERESTCOVG</i>	<b>0.168</b>	<b>0.185</b>	<b>0.149</b>	<b>0.160</b>
<i>p-value</i>	0.019	0.008	0.035	0.022
<i>CONFLICT</i>	0.030	0.006	0.048	0.024
<i>p-value</i>	0.670	0.931	0.508	0.733
<i>OTHERPROPOSAL</i>	-0.067	-0.096	-0.065	-0.091
<i>p-value</i>	0.273	0.104	0.294	0.133
<i>NONAPPROVEQUITY</i>	0.059	0.015	0.051	0.014
<i>p-value</i>	0.704	0.924	0.743	0.930
<i>VOLUNTEXP</i>	-0.007	-0.007	-0.007	-0.007
<i>p-value</i>	0.227	0.230	0.219	0.217
<i>HITECH</i>	0.158	0.123	0.181	0.144
<i>p-value</i>	0.175	0.234	0.133	0.182
<i>LAMBDA</i>	-0.011	-0.015	0.011	0.008
<i>p-value</i>	0.945	0.924	0.947	0.964
<i>N</i>	99	99	99	99

**TABLE 5 (Continuation)**  
**Determinants of Shareholders' Votes on Option Expensing Proposals**  
**(Dependent Variable: *NONINSIDER\_VOTES*)**

**Panel C: Second-Step Heckman Regression<sup>1</sup>**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Constant	<b>-0.968</b>	<b>-1.029</b>	<b>-1.007</b>	<b>-1.052</b>
<i>p-value</i>	0.024	0.013	0.023	0.015
<i>EXCESSOPTCEO</i>	<b>0.061</b>	<b>0.060</b>	<b>0.061</b>	<b>0.059</b>
<i>p-value</i>	0.004	0.002	0.004	0.002
<i>EXCESSOPTNONCEO</i>			0.014	0.007
<i>p-value</i>			0.688	0.837
<i>OPTEXPENSE</i>	-3.920		-4.279	
<i>p-value</i>	0.285		0.258	
<i>PROFTHRESH</i>		<b>-0.299</b>		<b>-0.300</b>
<i>p-value</i>		0.039		0.038
<i>INSIDEOWN</i>	<b>1.383</b>	<b>1.370</b>	<b>1.376</b>	<b>1.365</b>
<i>p-value</i>	0.001	0.001	0.001	0.001
<i>INSTOWN</i>	<b>0.492</b>	<b>0.492</b>	<b>0.483</b>	<b>0.487</b>
<i>p-value</i>	0.059	0.054	0.066	0.059
<i>LNSIZE</i>	<b>0.054</b>	<b>0.060</b>	<b>0.054</b>	<b>0.060</b>
<i>p-value</i>	0.088	0.044	0.091	0.044
<i>ADJRET</i>	<b>-0.162</b>	<b>-0.155</b>	<b>-0.165</b>	<b>-0.156</b>
<i>p-value</i>	0.023	0.016	0.021	0.016
<i>LEVERAGE</i>	<b>0.580</b>	<b>0.602</b>	<b>0.590</b>	<b>0.607</b>
<i>p-value</i>	0.038	0.029	0.036	0.029
<i>INTERESTCOVG</i>	<b>0.180</b>	<b>0.187</b>	<b>0.180</b>	<b>0.187</b>
<i>p-value</i>	0.046	0.034	0.046	0.034
<i>CONFLICT</i>	-0.044	-0.060	-0.040	-0.060
<i>p-value</i>	0.633	0.496	0.660	0.502
<i>OTHERPROPOSAL</i>	-0.089	-0.112	-0.090	-0.113
<i>p-value</i>	0.254	0.139	0.252	0.137
<i>NONAPPROVEEQUITY</i>	0.055	0.018	0.059	0.019
<i>p-value</i>	0.783	0.926	0.769	0.921
<i>VOLUNTEXP</i>	<b>-0.015</b>	<b>-0.014</b>	<b>-0.015</b>	<b>-0.014</b>
<i>p-value</i>	0.044	0.050	0.044	0.050
<i>HITECH</i>	0.101	0.108	0.121	0.114
<i>p-value</i>	0.498	0.416	0.443	0.403
<i>MILLS LAMBDA</i>	0.121	0.121	0.150	0.135
<i>p-value</i>	0.562	0.557	0.500	0.535
<i>N</i>	99	99	99	99

**TABLE 5 (Continuation)**  
**Determinants of Shareholders' Votes on Option Expensing Proposals**  
**(Dependent Variable: VOTES)**

**Panel D: Robustness Check - OLS Regression<sup>2</sup>**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Constant	<b>-1.057</b>	<b>-1.148</b>	<b>-1.055</b>	<b>-1.149</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>EXCESSOPTCEO</i>	<b>0.048</b>	<b>0.041</b>	<b>0.047</b>	<b>0.041</b>
<i>p-value</i>	0.001	0.001	0.001	0.001
<i>EXCESSOPTNONCEO</i>			0.012	0.002
<i>p-value</i>			0.555	0.902
<i>OPTEXPENSE</i>	<b>-5.376</b>		<b>-5.656</b>	
<i>p-value</i>	0.042		0.030	
<i>PROFTHRESH</i>		<b>-0.243</b>		<b>-0.243</b>
<i>p-value</i>		0.054		0.054
<i>INSIDEOWN</i>	<b>-2.072</b>	<b>-2.103</b>	<b>-2.086</b>	<b>-2.106</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>INSTOWN</i>	<b>0.925</b>	<b>0.906</b>	<b>0.930</b>	<b>0.906</b>
<i>p-value</i>	<0.001	<0.001	<0.001	<0.001
<i>LNSIZE</i>	0.036	<b>0.046</b>	0.034	<b>0.046</b>
<i>p-value</i>	0.148	0.052	0.168	0.054
<i>ADJRET</i>	<b>-0.159</b>	<b>-0.136</b>	<b>-0.161</b>	<b>-0.136</b>
<i>p-value</i>	0.022	0.037	0.021	0.039
<i>LEVERAGE</i>	<b>0.654</b>	<b>0.675</b>	<b>0.659</b>	<b>0.676</b>
<i>p-value</i>	0.026	0.016	0.026	0.017
<i>INTERESTCOVG</i>	<b>0.152</b>	<b>0.164</b>	<b>0.156</b>	<b>0.165</b>
<i>p-value</i>	0.074	0.046	0.071	0.050
<i>CONFLICT</i>	0.049	0.024	0.049	0.024
<i>p-value</i>	0.574	0.791	0.569	0.793
<i>OTHERPROPOSAL</i>	-0.048	-0.076	-0.048	-0.076
<i>p-value</i>	0.509	0.281	0.507	0.287
<i>NONAPPROVEEQUITY</i>	0.171	0.134	0.175	0.134
<i>p-value</i>	0.246	0.356	0.242	0.358
<i>VOLUNTEXP</i>	-0.006	-0.006	-0.006	-0.006
<i>p-value</i>	0.474	0.472	0.473	0.473
<i>HITECH</i>	0.193	0.151	0.200	0.151
<i>p-value</i>	0.115	0.161	0.108	0.162
Adjusted R <sup>2</sup> (N)	0.771 (103)	0.773(103)	0.772 (103)	0.773 (103)

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

<sup>1</sup> Results for the First Step of the Heckman Model (Probit Regression) are presented in Table 2, Panel C, Column 3

<sup>2</sup> Robust standard errors corrected for clustering (due to firms with a vote in both 2003 and 2004).

*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.

*OTHERPROPOSAL* = Dummy variable equal to 1 if the firm received another shareholder proposal dealing with executive compensation issues, 0 otherwise.

*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.