

**The Impact of Shareholder Activism on Financial Reporting and
Compensation: The Case of Employee Stock Options Expensing***

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Forthcoming at *The Accounting Review*

* We thank Dan Dhaliwal, Steven Kachelmeier, and two anonymous reviewers for their suggestions to improve the paper. Also, we thank Mark DeFond, Greg Miller, Kevin Murphy, K.R. Subramanyan, Jieying Zhang, and participants at the 2006 Financial Management Association Annual Meeting for their comments and suggestions. We are grateful to John Core and Wayne Guay for providing their industry classification and to David Huelsbeck for his research assistance. Special thanks to Ed Durkin, Director of Corporate Affairs Department at the United Brotherhood of Carpenters and Joiners of America (UBCJA) for extensive conversations on UBCJA's activity. All errors are our own.

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Abstract

We examine the economic consequences of more than 150 shareholder proposals to expense employee stock options (ESO) submitted during the proxy seasons of 2003 and 2004, the first case in which the SEC allowed a shareholder vote on an accounting matter. Our results indicate that these proposals affected accounting and compensation choices. Specifically, (i) targeted firms were more likely to adopt ESO expensing relative to a control sample of S&P 500 firms, (ii) among targeted firms, the likelihood of adoption increased in the degree of voting support for the proposal, and (iii) non-targeted firms were more likely to adopt ESO expensing when a peer firm was targeted. Additionally, (i) CEO pay decreased in firms in which the proposal was approved relative to a control sample of S&P 500 firms, and (ii) among targeted firms, approval of the proposal was associated with decreases in CEO compensation and the use of ESO in CEO pay. Our findings reveal an increasing influence of shareholder proposals on governance practices.

Keywords: Shareholder Activism; Corporate Governance; Financial Reporting; Executive Compensation; Stock Option Expensing

Data Availability: All data are publicly available from sources identified in the text.

I. Introduction

In 2002, following a number of high profile accounting scandals, regulators, legislators, capital market intermediaries, investors, and firms began to reconsider the accounting treatment of employee stock options (hereafter, ESO). The scandals were partly attributed to an accounting rule that essentially allowed firms to report no compensation expense for ESO.¹ In particular, it was argued that the favorable reporting treatment had led to an excessive use of option-based compensation (e.g., Bodie et al. 2003; Hall and Murphy 2003) that “*perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising*” (Greenspan 2002). Indeed, subsequent studies suggested a systematic link between the use of stock options and degree of earnings management and likelihood of accounting restatements (Bergstresser and Philippon 2006; Burns and Kedia 2006; Efendi, et al. 2007). Critics also pointed to other questionable practices induced by extensive use of option-based pay such as the opportunistic timing of grant dates and opportunistic release of financial information around option grants and exercises (Aboody and Kasznik 2000; Bartov and Mohanram 2004; Ferri 2005; Yermack 1997). The ensuing debate led eventually to the Financial Accounting Standards Board (FASB) releasing in December 2004 a revised rule, SFAS No.123R, that required all firms to expense ESO based on fair value at grant date.

As the debate escalated in the latter part of 2002, a group of shareholders (predominantly union pension funds) targeted a number of firms with a proposal requesting an advisory

¹ At that time, the Statement of Financial Accounting Standards (SFAS) No. 123 (issued in 1995) allowed a company to account for ESO using either the *fair value method* or the *intrinsic value method* (prescribed since 1972 by Accounting Principles Board Opinion No. 25). All companies electing the intrinsic value method were required to make pro forma disclosures of net income as if the fair value based method had been applied. Under the fair value method, compensation cost is measured through an option-pricing model at the grant date, whereas under the intrinsic value method compensation cost is calculated as the difference between the firm’s stock price and the exercise price on the grant date. Since the exercise price is typically set equal to the stock price on the grant date, the intrinsic value method essentially results in no compensation cost for ESO being recognized in the income statement. Until 2002, virtually all firms opted for the intrinsic value method.

shareholder vote on whether ESO should be expensed.² More than 150 shareholder proposals on this matter were submitted during the 2003 and 2004 proxy seasons. To shed light on the broader question of whether shareholder votes influence management decisions and governance practices, despite their advisory nature, we assess the economic consequences of the ESO expensing proposals by analyzing their impact on (a) the rate of voluntary adoption of ESO expensing prior to the release of SFAS No.123R, and (b) the level and composition of CEO pay.

We find that firms targeted by ESO expensing proposals were more likely to subsequently adopt ESO expensing relative to a control sample of S&P 500 firms. In particular, the presence of a proposal is associated with a 10.65 percent increase (from 5.99 percent to 16.64 percent) in the probability of adopting ESO expensing. The result is robust to a correction for endogeneity to address the concern that firms were targeted for reasons related to the likelihood of adoption. Also, the likelihood of adoption among targeted firms increases in the degree of voting support for the proposal. Finally, we find that non-targeted firms were more likely to adopt ESO expensing when a peer firm (i.e., a firm in the same four-digit SIC industry code) was targeted by an ESO expensing shareholder proposal.

With respect to compensation practices, we find that targeted firms subsequently experienced a decrease in the *level* of CEO compensation relative to a control sample of S&P 500 firms. Further analysis shows this finding to be entirely driven by the subset of targeted firms in which the proposal was approved. In particular, the approval of an ESO expensing proposal is associated with a subsequent decrease of approximately \$2.29 million in CEO compensation (versus an increase of \$0.34 million in non-targeted firms). Also, among targeted firms receiving a vote, there is a negative relation between approval of the proposal and the subsequent change

² Hereafter, for simplicity, we will refer to the adoption of the fair value method of ESO accounting as adoption of 'ESO expensing,' and the related proposals will be termed 'ESO expensing proposals.'

in CEO compensation. As for the *composition* of CEO compensation, the percentage of total pay represented by ESO does not change for targeted firms relative to non-targeted firms. However, approval of the proposal and the change in the percentage of total pay represented by ESO are negatively related in targeted firms receiving a vote. In particular, the relative weight of ESO in CEO pay increased by 3.2 percentage points in firms in which the proposal was not approved, and decreased by 7.8 percentage points in firms in which it was approved. The results are robust to eliminating the effects of firms being targeted in both 2003 and 2004, and to other potential drivers of compensation changes such as the contemporaneous adoption of ESO expensing.

Overall, our evidence of significant effects on CEO compensation and voluntary adoption of a key accounting method suggests a growing influence of shareholder proposals and shareholder votes on governance practices.

Our study contributes to the accounting literature that relates shareholder behavior to accounting choices. Previous research that examined the association between shareholders' composition and reporting choices generally concluded that investors exhibit a preference for particular accounting methods, in that they tend to invest in firms with certain reporting characteristics (Bradshaw et al. 2004; Bushee 2001). However, there is little or no evidence that investors take observable actions to affect those choices.³ We contribute to this literature by providing compelling evidence of a direct mechanism (shareholder proposals) through which shareholders not only expressed their preference for a voluntary accounting choice (the adoption

³ Bradshaw et al. (2004) find a relation between accounting choices and U.S. institutional investor ownership in a sample of non-U.S. firms, with U.S. investors exhibiting a preference for accounting methods that conform to U.S. GAAP. However, although increases in U.S. GAAP conformity precede increases in U.S. institutional holdings, increases in ownership by U.S. institutional investors are not followed by an increase in U.S. GAAP conformity. This evidence suggests that accounting choices and methods are one component of investors' preferences set, but investors do not affect the accounting choices of the firms they invest in. Park and Shin (2004) find some evidence that the presence of active institutional shareholders on the board of directors is associated with a reduction in the use of income-increasing accrual manipulations to meet earnings targets, but draw no causality inferences.

of ESO expensing) but also successfully pressured management to adopt the preferred accounting method, with spillover effects on non-targeted firms.

Our research also contributes to the literature on executive compensation. Previous studies find no evidence that compensation-related shareholder proposals during the mid-1990s influenced the level or composition of CEO compensation (Johnson and Shackell 1997; Thomas and Martin 1999). In contrast, we find that ESO expensing proposals were associated with subsequent changes in the level and composition of CEO pay in targeted firms in which the proposal received higher voting support. This evidence is of particular importance to policy-makers debating the introduction of a mandatory advisory annual shareholder vote (known as the “say on pay” vote) on the executive compensation report included in the proxy statement.⁴

Finally, we contribute to a growing line of research on shareholder activism. In particular, our findings complement recent evidence that suggests greater influence of shareholder proposals and votes on corporate decisions in the post-SOX environment (e.g., Del Guercio et al. 2008; Ertimur et al. 2008a; Guo et al. 2008; Thomas and Cotter 2007). This evidence is of great relevance as the Securities and Exchange Commission (SEC) is currently re-examining the proxy voting process (SEC 2007), and some critics have suggested eliminating advisory resolutions from the proxies due to their limited effects (Baue 2007). Also, previous studies focused mostly on the impact on targeted firms; our study is the first to respond to Karpoff’s (2001) call to examine the existence of spillover effects on non-targeted firms.

The remainder of the paper is organized as follows. In Section II, we describe the institutional background of shareholder proposals. In Section III we develop predictions on the

⁴ A bill seeking to mandate a “say on pay” vote was approved by the House of Representatives in April 2007. Shortly thereafter, an analogous bill was introduced in the Senate by presidential candidate Barack Obama. Besides, between 2006 and 2008, shareholder activists led by AFSCME (a union pension fund) targeted more than 150 US firms with non-binding shareholder proposals requesting the adoption of “say on pay” (Ferri and Maber 2008).

economic consequences of ESO expensing shareholder proposals. In Section IV, we describe the sample, discuss the motives of the proponents, and examine characteristics of the targeted firms. In Sections V and VI, we outline our methodology and define the variables used in the tests, and analyze the effects of the proposals on firm behavior with regard to the adoption of ESO expensing and compensation choices. Section VII concludes.

II. Institutional Background: Shareholder Proposals under Rule 14a-8

Under Rule 14a-8 of the Securities Exchange Act of 1934, any shareholder continuously holding shares worth at least \$2,000 (or 1 percent of the market value of equity) for one year or more is allowed to include one (and only one) proposal with a 500-word supporting statement in the proxy statement distributed by a company for its annual shareholder meeting. These proposals request a vote in favor or against a particular issue (e.g., the expensing of ESO) from all shareholders and must be submitted to the company at least 120 days before the proxy statement is mailed to shareholders prior to the annual meeting. The board of directors might persuade the proponent to withdraw the proposal (and thus avoid a shareholder vote) either by agreeing to it or by agreeing to other concessions. Alternatively, the board might request the SEC to exclude a proposal that violates certain conditions.⁵ The SEC then issues a no-action letter that determines whether the proposal is to be included (sometimes in a revised format). Proposals neither withdrawn nor excluded will be included in the proxy statement and voted upon at the annual meeting by all shareholders of record as of a given date indicated in the proxy materials.

⁵ Under Rule 14a-8(i), firms may request the exclusion of proposals that address ordinary business matters, proposals related to an election for membership on the company's board of directors, and proposals that request specific amounts of cash and stock dividends, among other reasons. A proposal may also be excluded if it conflicts with one of the management proposals to be submitted to shareholders at the same meeting, or if it had been already submitted in the past and had received less than a certain percentage of votes in favor (3% if presented once, 6% if presented twice, 10% if presented three times). See <http://www.sec.gov/interp/leg/cfs14.htm>.

Among the reasons for shareholder proposal exclusion, two are of particular relevance to our study. First, proposals might be excluded if considered improper under the company's state laws. Proposals binding on a company are generally regarded as improper, reflecting states' aversion to limit a board's ability to exercise business judgment and its fiduciary role. As a result, almost all proposals to the board are written as non-binding recommendations (Black 1990). Second, proposals might be excluded if they deal with a matter related to the company's "ordinary business." Over time, the SEC has taken a more liberal stance on the interpretation of this provision. For example, since 1992 the SEC has allowed proposals on executive pay, originally excluded as deemed to be dealing with "ordinary business" (Johnson and Shackell 1997).

Accounting matters were not the subject of shareholder proposals until the summer of 2002, when shareholders targeted a number of firms with a non-binding proposal to expense ESO (see Section IV). In July 2002, one of the targeted firms, National Semiconductor, requested that the SEC omit the proposal on the basis that the choice of accounting methods represented an "ordinary business" matter. The SEC staff concurred with this view. This decision raised criticism among observers, however, and in December 2002 the SEC reversed its position on the grounds that the accounting treatment of ESO had become a "social policy" issue. As a result, more than 150 shareholder proposals to expense ESO were submitted during the 2003 and 2004 proxy seasons. These proposals constitute the sample we analyze.

III. Empirical Predictions

Effect of shareholder proposals on the adoption of ESO expensing

In considering the consequences of the 2003-2004 ESO expensing proposals, the most immediate question is whether these proposals were eventually adopted by targeted firms, that is, whether targeted firms decided to expense ESO. The empirical evidence from the 1980s and

1990s generally indicates a weak impact of shareholder proposals on the governance practices of targeted firms (Black 1998; Gillan and Starks 1998, 2007; Karpoff 2001; Romano 2001). In part, the limited effects reflected the fact that most proposals, usually submitted by individual investors, garnered little voting support (e.g., Del Guercio and Hawkins 1999; Gillan and Starks 2000; Gordon and Pound 1993; Wahal 1996).

However, three considerations lead us to predict greater effectiveness in the case of ESO expensing proposals. First, starting in the summer of 2002, the accounting treatment for ESO received greater media coverage than the issues underlying most other shareholder proposals, in part, because of the alleged role of ESO in the recent wave of accounting scandals. Hence, targeted firms' actions in response to ESO expensing proposals were likely to be subject to particularly close scrutiny (e.g., La Monica 2004; Lavelle 2003). Second, as detailed in Appendix 1, broad support for ESO expensing built quickly, fueled by the voluntary adoption by high-profile firms and public statements by influential corporate governance advocates and business leaders such as Warren Buffett (*New York Times* 2002) and Alan Greenspan (*Globe and Mail* 2002). Those statements were often cited by shareholders submitting ESO expensing proposals (see Appendix 2).⁶ As a result, the managerial reputation cost associated with opposing these proposals was potentially quite high. Finally, unlike most shareholder proposals, ESO expensing proposals received significant voting support, nearly half garnering a majority vote (see Section IV). After the Enron-type scandals and passage of Sarbanes-Oxley, the cost of ignoring shareholder proposals supported by a majority vote increased significantly as shareholder activists, governance rating agencies, proxy voting services, and the press began to

⁶ Aboody et al. (2004) report that Warren Buffett was a member of the board (or Berkshire Hathaway an investor in) 12 of the 155 firms (analyzed in their study) that voluntarily adopted ESO expensing in 2002.

single out unresponsive firms.⁷ Besides, a high degree of voting support tends to galvanize proponents and result in more intense follow-up pressure.⁸ High voting support might also persuade the board that the proposal is in the best interest of the company. Consistent with these arguments, Ertimur et al. (2008a) found that the frequency of implementation of majority-vote proposals nearly doubled after 2002 (exceeding 40 percent in 2003-2004), that the likelihood of implementation increases with the degree of voting support, and that unresponsive board members are penalized in the director labor market.

In light of the foregoing arguments, we make the following predictions regarding the impact of ESO expensing proposals on targeted firms.

Prediction 1. *We predict a higher likelihood of voluntary expensing of ESO in:*

- a. firms targeted by an ESO expensing shareholder proposal,*
- b. targeted firms in which the proposal receives higher voting support.*

In addition to precipitating change in the targeted firms, shareholder proposals might have spillover effects on the actions of other firms, a possibility recognized but not examined in previous research.⁹ Our setting is well suited to examine this question, as the incentives to promote spillover effects are particularly strong for union pension funds, which mostly operate as indexed funds (Del Guercio and Hawkins 1999; Kahan and Rock 2007). We conjecture that the presence of an ESO expensing shareholder proposal at a targeted firm might lead peer firms'

⁷ In recent years, directors failing to implement majority-vote proposals have become the target of "vote-no" campaigns, with negative effects on their reputation in their labor market (Del Guercio, Wallis, and Woidtke 2008). One of the most influential proxy voting services (Institutional Shareholder Services 2006) recommends that shareholders withhold votes from directors failing to adopt a proposal supported by a majority of votes. Firms ignoring majority vote proposals are singled out in CalPERS Focus List (CalPERS 2007), receive lower ratings from governance services, such as The Corporate Library, and attract negative press coverage (CFO.com 2003).

⁸ For example, after the 2007 proxy season, the Council for Institutional Investors, a nonprofit association of pension funds with combined assets exceeding \$3 trillion, sent a series of letters to all firms in which shareholder proposals received a majority vote urging implementation (Riskmetrics 2008).

⁹ Del Guercio and Hawkins (1999) report some indirect anecdotal evidence of spillover effects (e.g., interviews with top CalPERS officials stating that non-targeted firms pay attention to CalPERS' interactions with target firms). In his

boards to adopt ESO expensing in order to avoid a similar proposal. Firms might have perceived “voluntary” adoption of ESO expensing to be a less costly outcome for two reasons. First, firms might be motivated “to proactively improve their corporate governance structures without being explicitly targeted” (Del Guercio and Hawkins 1999) to avoid publicity. In our setting, the high visibility of the proposals was likely to increase scrutiny of firms’ executive pay practices.¹⁰ For example, shareholder proponents’ supporting statements suggested that lack of ESO expensing had resulted in excessive use of ESO for compensation (see Appendix 2 for specific examples).

Second, in the event of a majority vote (a real possibility given the broad support for ESO expensing among institutional investors) the firm would have had to choose between adopting ESO expensing anyway and ignoring the shareholders’ vote, with negative consequences for firms’ and directors’ reputations (discussed earlier in ftnt.7). These arguments lead us to advance the following prediction.

Prediction 1. *We predict a higher likelihood of voluntary expensing of ESO in:*

- c. non-targeted firms in industries in which at least one other firm is targeted by an ESO expensing shareholder proposal.*

Effect of shareholder proposals on CEO compensation

Our second set of predictions concerns the effect of ESO expensing proposals on CEO compensation practices. Although technically focused on an accounting issue, ESO expensing proposals encouraged scrutiny of executive pay, as proponents’ statements and many observers explicitly traced excessive use of options to the accounting treatment (see Introduction and

review paper, Karpoff (2001) notes the lack of empirical analysis of spillover effects and asks: “Are non-target companies affected, for example, when other firms in the same industry...attract activist efforts?”

¹⁰ Previous research suggests that managers try to avoid scrutiny of their compensation packages. Firms paying larger amounts of compensation to their executives are more likely to (i) lobby against more explicit forms of disclosure of executive pay (Dechow et al. 1996; Hill et al. 2002), (ii) disavow (Blacconiere et al. 2004) and manage downward the option expense disclosed (Aboody et al. 2006) or recognized (Johnston 2006) under SFAS 123, and (iii) have poorer voluntary disclosure of compensation practices in the proxy statements (Laksmana 2008).

Appendix 2).¹¹ Previous research that examined the effects of compensation-related shareholder proposals in the 1990s found that such proposals received low voting support (votes in favor averaging less than 15 percent) and had virtually no effect on the level and composition of CEO compensation.¹² There are two reasons to expect a stronger impact in the case of ESO expensing proposals. First, in the aftermath of the accounting scandals and collapse of the technology sector (which relied heavily on the use of ESO) in 2001 and 2002, investor sentiment regarding executive compensation and ESO, in particular, had become increasingly negative (Bartov and Hayn 2006), paving the way for an unprecedented degree of investor scrutiny of executive compensation.¹³ It is conceivable that targeted firms' boards and management decided to take action with respect to CEO pay (regardless of their decision to adopt ESO expensing) to prevent more detrimental outcomes (e.g., vote-no campaigns against the board or regulatory intervention) and reduce the degree of scrutiny. Specific actions might have included downward pressure on pay levels and a shift away from stock options towards other forms of compensation.

Second, unlike the compensation proposals presented in the 1990s, ESO expensing proposals received significant voting support.¹⁴ As we argued leading up to Prediction 1b, we expect stronger effects in firms in which voting support for the proposals was higher.

¹¹ Ferri et al. (2008) find that voting support for ESO expensing was higher in firms with higher use of ESO (relative to their peers), consistent with investors expecting that either the adoption of ESO expensing or the visibility of the proposal would lead firms to revise their compensation practices, and, in particular, reduce the use of ESO.

¹² Johnson and Shackell (1997) analyze 169 compensation-related proposals submitted between 1992 and 1995. Most of these proposals were sponsored by individual shareholders and called for lower CEO pay, increased compensation disclosure, and independence of the compensation committee. Average voting support was 13%, with none of the proposals receiving a majority vote and no significant effect on subsequent compensation levels. Thomas and Martin (1999) analyze 168 compensation-related proposals over the 1993-1997 period and find no significant changes in the level or composition of CEO compensation.

¹³ The number of compensation-related proposals submitted at S&P 1500 firms jumped from 320 between 1998 and 2002 to 720 between 2003 and 2007 (Ertimur et al. 2008b). At the same time, activists resorted to highly publicized vote-no campaigns against compensation committee members (e.g., at Home Depot and Pfizer). The press and governance rating agencies (e.g., The Corporate Library) also contributed to keeping CEO pay in the headlines.

¹⁴ A third argument is that ESO expensing proposals had greater impact than prior compensation-related proposals because they benefited from intense media coverage. However, previous studies document a modest impact of negative press coverage on CEO compensation (Johnson et al. 1997; Core et al. 2008).

Prediction 2. *We predict a lesser increase (or greater decrease) in CEO total compensation and use of stock options in CEO compensation in:*

a. firms targeted by an ESO expensing shareholder proposal,

b. targeted firms in which the proposal receives higher voting support.

An alternative view is that shareholder proposals are ineffective because they are non-binding and can be ignored at essentially no cost to management (Karpoff et al. 1996; Wahal 1996), in which case Predictions 1 and 2 would not be supported by the data.

IV. Sample Selection and ESO Expensing Shareholder Proposals

Primary sample. Our primary sample consists of all ESO expensing shareholder proposals submitted during the 2003 and 2004 proxy seasons, which correspond to the period from the SEC's decision to allow ESO expensing shareholder proposals (December 2002) to the FASB's release of SFAS No.123R mandating the fair value method of accounting for ESO (December 2004). To identify these proposals, we perform a keyword search of the proxy statements of all SEC registered firms using a search string of the words "Proposal" and "Expensing" within a distance of six words. We then verify this list vis-à-vis other online references (The Corporate Library, Georgeson Shareholder). We complement this search with a list of proposals submitted and withdrawn (and thus not included in the proxy statements) provided by the United Brotherhood of Carpenters and Joiners of America (UBCJA). Including withdrawn proposals (often not available to researchers) is crucial to capture the full impact of shareholder proposals on firms' behavior, one reason for withdrawal being that the firm took action to address the proponents' requests (e.g., Del Guercio and Hawkins 1999; Strickland et al. 1996). Our search yielded 153 shareholder proposals (in 131 firms), 107 of which were voted upon at the annual meeting (Table 1, Panel A).

Control sample. Given that 95 percent of the targeted firms are either in the S&P 500 index or larger in size than the smallest firm in the S&P 500, our control sample consists of non-targeted firms in the S&P 500, excluding those already expensing ESO as of December 2002. The resulting control sample consists of 320 firms (Table 1, Panel B).

[TABLE 1 APPROX. HERE]

Data sources. We hand-collected information about the ESO expensing proposals as well as any other compensation-related proposals (voting outcome, voting turnout, identity of proponents, date of annual meeting, and so forth) from the proxy statement prior to, and the 10Q report following, the annual meeting. We obtained additional data from seven other sources: CRSP (stock price returns and volatility), Compustat (financial data and industry classification), ExecuComp (CEO and directors' pay), Thompson Financial (institutional ownership), Securities Data Corporation (acquisitions and equity issuance), 10-Ks and the Bureau of Labor Statistics (percentage of unionized employees at firm and industry level, respectively), and the December 16, 2004 Equity Research Report by Bear Stearns (list of firms voluntarily expensing ESO).

Below, we summarize the outcomes of the proposals, discuss proponents' motivations, and describe the characteristics of targeted firms.

Shareholder Proposals and Voting Outcome

As shown in Table 2, Panel A, votes in favor ("Votes For") ESO expensing proposals averaged 47 percent of all votes cast, resulting in 47.7 percent of the proposals (51 out of 107) being approved, one of the highest approval rates for a shareholder proposal (Ertimur et al. 2008a). Other compensation-related shareholder proposals submitted to the same firms during the same period averaged about 20 percent Votes For.¹⁵ Even more tellingly, Votes For as a

¹⁵ Fifty-four of the 153 targeted firms received one (44 firms) or more (10 firms) other compensation-related proposals at the same annual meeting, resulting in 72 compensation-related proposals (excluding ESO expensing

percent of votes cast by shareholders other than insiders averaged 56.9 percent, and represented the majority (of non-insider votes) in 72 percent of the firms (77 out of 107, untabulated).

Shareholder support increased over time, 60 percent of ESO expensing proposals being approved in 2004 compared to 41.7 percent in 2003 (see the third row of Table 2, Panel A). Notably, 69.2 percent of 13 proposals presented for the first time in 2004 were approved, but voting support also increased in firms targeted both in 2003 and 2004,¹⁶ perhaps due to the perception that ESO expensing was unavoidable in the wake of the FASB Exposure Draft issued in March 2004. The favorable voting outcomes, combined with high voter turnout and low abstention rates (Table 2, Panel A), suggest that shareholders believed the proposals, despite their non-binding nature, were likely to influence management and board behavior.

[TABLE 2 APPROX. HERE]

Proponents' Motivation

Table 2 Panel A reveals that 90 percent of ESO expensing proposals were sponsored by union pension funds that held shares in the targeted firms. The ESO expensing initiative was launched in the summer of 2002 by a group of union pension funds led by the United Brotherhood of Carpenters and Joiners of America (UBCJA), a representative of which told us that the objective was to persuade the FASB to reconsider the accounting treatment of ESO and

proposals). These proposals included: adoption of performance-based options plans such as indexed options or options with performance-based vesting conditions (38 cases); requirement for shareholder approval of large golden parachutes (7); replacement of options with performance-based restricted stock (5); exclusion of pension income from net income in determining executive bonuses (4); prohibition of issuance of stock option grants (2); requirement that executives retain a certain percentage of equity awards (3); mandating of a cap on executive pay (2); requirement for shareholder approval of certain supplemental executive retirement benefits (2); and others (9).

The average (median) percentage of votes cast in favor of these proposals was 24.4 percent (16.4 percent). Only eight of these 72 proposals received a majority vote (five proposals requiring shareholder approval of large golden parachutes, one proposal requiring shareholder approval of certain supplemental executive retirement benefits, one proposal requiring shareholder approval of all equity compensation plans, one proposal requiring exclusion of pension income from net income in determining executive bonuses).

¹⁶ The percentage of Votes For increased in 20 of the 22 firms targeted in both 2003 and 2004 (see Table 2, Panel B), resulting in approval of the proposal in 41.2 percent of the firms in which it had been rejected in 2003 including some high-profile cases among tech firms such as Hewlett Packard, IBM, and Intel.

generate debate on the effectiveness of option-based compensation and executive compensation in general. According to UCBJA, excessive use of stock options and their distorted incentive effects had negatively affected pension fund values. Hence, lobbying for the expensing of ESO was viewed as consistent with the objective to maximize pension fund returns.

Labor unions had over the past fifteen years been playing an increasingly significant role as shareholder activists through their pension funds, sponsoring approximately 26 percent (48 percent) of all governance-related (compensation-related) proposals submitted under Rule 14a-8 between 1997 and 2004, peaking at more than 40 percent (65 percent) in 2003-2004 (Ertimur et al. 2008a).¹⁷ Schwab and Thomas (1998) suggest that a key objective of shareholder activism by unions (in addition to maximizing pension fund value) was greater involvement in strategic corporate decisions. By sponsoring widely supported corporate governance proposals (e.g., redemption of poison pills, declassification of boards of directors), unions had tried to enhance their credibility as sophisticated players in the investment community and capture the attention of directors often less inclined to grant them the same informal communication opportunities accorded other institutional investors.

In this respect, proposals to expense ESO proffered four appealing features. First, wide support for ESO expensing among institutional investors (e.g., McKinsey 2002) suggested a high probability of a successful voting outcome. Second, it represented a new, unique proposal (the first ever on an accounting issue) for which unions would be given full credit. Third, although technically focused on an accounting treatment, the initiative would attract attention to executive

¹⁷ The increasing use of shareholder proposals by union pension funds begs the question of why they file proposals rather than “vote with their feet” by selling stock in firms with an undesirable governance practice (in this case, lack of ESO expensing). However, “voting with their feet” is a more attractive option for actively managed funds in response to a firm-specific issue than for indexed funds (such as union pension funds) in response to systemic, market-wide issues (such as ESO expensing). In the second case, promoting an initiative with a potential for significant spillover effects is viewed as a superior strategy (for a discussion, see Black 1990; Del Guercio and

pay and thus had the potential to affect executive pay practices, an area in which prior shareholder proposals had not been effective (Johnson and Shackell 1997; Thomas and Martin 1999) and traditionally of great interest to unions.¹⁸ Finally, the proposal afforded unions an opportunity to influence the standard setting process on a topic of great visibility.

Characteristics of Targeted Firms

The characteristics of targeted firms are likely to reflect the proponent's motivations. Both of the unions' stated objectives, change the accounting treatment of ESO and spur debate on compensation practices, were more likely to be achieved if the proposals received high voting support, if the votes generated significant media attention, and if the target firms were regarded as broadly representative of the underlying population. The unions claimed to be targeting an approximately "random" sample of firms, but explicitly biased towards *large* firms more likely to receive extensive press coverage.¹⁹ Indeed, Ferri et al. (2008) found the targeted firms to be distributed across multiple industries and about five times larger than the average Compustat firm (\$27.1bn versus \$5.3bn in total assets).

Using a logit regression over the two-year window 2003-2004, we try to infer empirically other targeting criteria possibly used by the proponents by comparing targeted firms with the control sample of S&P 500 firms described earlier. Following Ferri et al. (2008), we include the

Hawkins 1999). In addition, since no firm was expensing ESO until the summer of 2002, in our setting "voting with their feet" would have been equivalent to exiting the equity market.

¹⁸ In 1997 the AFL-CIO launched the Executive Paywatch Web site to monitor CEO pay trends and denounce cases of excessive pay, with emphasis on the growing gap between pay levels for CEOs and average workers. Since then, unions have been the major proponent of compensation-related proposals, accounting for 65 percent of them in 2003-2004 (Ertimur et al. 2008a). Most compensation-related proposals submitted during the 1990s by union funds focused on the independence of the compensation committee and levels of CEO pay, whereas over the last few years most proposals have focused on creating a better link between pay and performance (e.g., through the use of performance-based options) and giving shareholders a vote on golden parachutes and supplemental executive retirement benefits (Ertimur et al. 2008b).

¹⁹ In the words of Edward Durkin, director of corporate affairs at United Brotherhood of Carpenters and Joiners of America, "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).

number of options held by the CEO (scaled by total shares outstanding, *OPTCEO*), an indicator variable for high-tech firms (dummy *HITECH*), and the magnitude of the “pro forma” ESO expense disclosed in the footnotes under SFAS 123 (scaled by the market value of equity, *OPTEXPENSE*).²⁰ We also include the percentage of unionized employees (*UNION*) to capture other unions’ objectives in targeting a firm.²¹

Finally, we include a number of control variables found in prior studies to be associated with the likelihood of being targeted by shareholder proposals (e.g., Bizjak and Marquette 1998; Johnson and Shackell 1997; Karpoff et al. 1996; Strickland et al. 1996; Thomas and Cotter 2007; Wahal 1996). These include firm characteristics such as size (natural logarithm of the market value of equity, *LNMVE*), growth options (market-to-book value of equity, *MB*), past performance (cumulative three-year stock returns, *RETURNS*), and leverage (debt to total assets ratio, *LEVERAGE*) as well as ownership and governance characteristics such as the percentage of equity held by institutional investors (*INSTOWN*) and executives (*EXECOWN*) and the percentage of the top five executives serving on the board of directors (*EXECONBOARD*).

[TABLE 3 APPROX. HERE]

Consistent with Ferri et al. (2008), Table 3 shows that, relative to the other S&P 500 firms, firms with higher CEO option holdings (*OPTCEO*), lower magnitude of disclosed ESO expense (*OPTEXPENSE*), and high-tech firms (*HITECH*) are more likely to be targeted. Targeted firms

²⁰ Ferri et al. (2008) argue that proponents would prefer to target firms with high use of executive stock options, such as high-tech firms or firms in which CEOs hold a large amount of options, on the ground that voting shareholders in these firms would support ESO expensing as a way to curb excessive use of stock options and mitigate executives’ incentives to artificially inflate earnings. They also argue that, all else being equal, proponents would target firms with lower magnitudes of pro forma option expense because some voting shareholders might vote against ESO expensing out of concern for negative effects associated with lower reported income.

²¹ Critics argue that unions engage in shareholder activism to gain bargaining power over future wage and benefit negotiations rather than to maximize the value of the union pension fund (Agrawal 2008). However, in our sample, the unions sponsoring the proposals represent employees from the respective firms only in four of the 153 targeted firms. Nonetheless, to allow for the possibility that unions may strategically coordinate their activities to avoid the appearance of a conflict of interest, we define *UNION* as the percentage of unionized

also tend to have higher *LEVERAGE* (Karpoff et al. 1996) and lower institutional ownership *INSTOWN* (Johnson and Shackell 1997).

Replicating these analyses separately for 2003 and 2004, we find the results (untabulated) to be unchanged, except that *RETURNS* and *EXECONBOARD* become significantly and negatively related to a firm's probability of being targeted, consistent with prior research (Ertimur et al. 2008a; Wahal 1996). Note that in none of these specifications does the percentage of unionized employees (*UNION*) appear to be a significant selection criterion. We use the logistic model in Table 3 to account for a potential selection bias in the analysis of the consequences of ESO expensing proposals.²²

V. Evidence of Whether Shareholder Proposals Affect the Adoption of ESO Expensing

Research Design

To test Prediction 1a (the effect of being targeted on the likelihood to expense ESO) we employ the following logit regression:

$$\begin{aligned} \Pr(VOLEXP_i = 1) = & \alpha_0 + \alpha_1 * TARGETED_i + \alpha_2 * PEER_VOLEXP_i + \alpha_3 * INSTOWN_i \\ & + \alpha_4 * ISSUE_i + \alpha_5 * ACQ_i + \alpha_6 * DEBTEQ_i + \alpha_7 * INTCOV_i \\ & + \alpha_8 * BONUS_i + \alpha_9 * CEOOWN_i + \alpha_{10} * ODIRGRANT_i + \alpha_{11} * LNMVE_i \\ & + \alpha_{12} * PROFIT_i + \alpha_{13} * OPTTOP5_i + \alpha_{14} * OPTEXPENSE_i \\ & + \alpha_{15} * IndustryDummies + \varepsilon_i \end{aligned} \quad (1)$$

Our research question is whether *after* being targeted by an ESO expensing proposal (dummy *TARGETED*) a firm is more likely to voluntarily adopt ESO expensing (dummy *VOLEXP*=1 if the firm voluntarily expenses options, 0 otherwise). The date a firm receives a proposal is not

employees, regardless of whether one of the unions representing the employees at the targeted firm is the union sponsoring the proposal. Thirteen percent of the targeted firms have at least some unionized employees.

²² The explanatory power of the model appears to be low (Pseudo R-square=0.07). Note, though, that (a) we are already implicitly controlling for size, the main selection criterion (Ferri et al. 2008), by focusing on the S&P 500 firms, (b) a low explanatory power (after controlling for the S&P 500 membership) is consistent with the union pension funds' objective to target a random sample of firms, (c) the values of the Pseudo R-square cannot be

observable. Under Rule 14a-8, a proposal must be submitted at least 120 prior to the proxy mailing date. Hence, any adoption of ESO expensing announced after this deadline is certainly occurring after the proposal was received. Adoptions announced before the deadline might have occurred before or after the targeting date. There are only seven such cases in our sample of targeted firms. We exclude three of these because they announced their decision to expense ESO more than 100 days before the deadline for proposal submission (see Table 1, Panel A). In the other four cases, the decision was announced 7, 26, 27, and 34 days before the deadline. Assuming that these four firms announced their decision to expense ESO after receiving the proposal, we code them as $VOLEXP=1$. The results are robust to their exclusion.

To test Prediction 1b (the effect of the voting outcome on the subsequent ESO expensing decision), we restrict the analysis to the sub-sample of firms in which the proposal was voted on and replace the independent variable *TARGETED* in equation 1 with *VOTESFOR*, the percentage of votes cast in favor of the proposal. We do not use an indicator variable (approved vs. not approved) because there were no cases of adoption of ESO expensing in firms in which the proposal was not approved. For firms in which a vote occurred both in 2003 and 2004 (Table 2, Panel B) we include only one observation per firm, using the 2004 voting outcome.²³ The results are robust to using only the 2003 voting outcome.

To test Prediction 1c (the effect of the shareholder proposals on the subsequent ESO expensing decision by non-targeted firms within the same industry), we restrict our sample to non-targeted firms and replace the independent variable *TARGETED* in equation 1 with the indicator variable *PEER_TARGETED*, which is equal to 1 if at least one other firm within the

naturally interpreted, there being no standard by which to assess whether the value is “large enough” (Greene 2003, 683; Long 1997, 105). Thus, a Pseudo R-square of 0.07 does not imply that the fit of the model is inadequate.

²³ The only exception is Safeway, for which we include the voting outcome in 2003 because the firm announced the decision to expense ESO before the 2004 vote (see notes to Table 2, Panel B).

same four-digit SIC was previously targeted by an ESO expensing proposal, and 0 otherwise. For all non-targeted sample firms with *PEER_TARGETED*=1, the announcement of ESO expensing (if any) occurs after the (earliest) date one of the peer firms is targeted by the proposal.

We control for other potential determinants of a firm's decision to expense ESO analyzed in Aboody et al. (2004). Voluntary adoption of ESO expensing might be used to signal favorable future prospects in firms with higher information asymmetries and capital market activity. Hence, we predict a higher likelihood of ESO expensing in firms with higher information asymmetry (measured as a lower percentage of institutional ownership, *INSTOWN*) and higher capital market activity, that is, firms that issued equity to raise cash (dummy *ISSUE*) or acquire another firm (dummy *ACQ*) during the previous three fiscal years, or firms with a high debt to equity ratio (*DEBTEQ*) and high interest coverage (*INTCOV*).

Due to management's private incentives, the likelihood of expensing might be higher in cases in which the CEO bonus is a lower fraction of total pay (*BONUS*) and equity ownership by the CEO (*CEOOWN*) and outside directors (*ODIRGRANTS*) is higher, assuming positive valuation effects from the expensing announcement (Aboody et al. 2004). Also, ESO expensing might be more likely in firms subject to larger political costs, measured in terms of firm size (the natural log of the market value of equity, *LN MVE*), profitability (net income scaled by market value of equity, *PROFIT*), and fraction of all options granted to the top five executives (*OPTTOP5*).

To complete the set of determinants of ESO voluntary adoption described by Aboody et al. (2004), we control for the magnitude of the pro forma option expense disclosed under SFAS 123 (scaled by market value of equity, *OPTEXPENSE*). The relation between *OPTEXPENSE* and the decision to expense ESO is unclear. A higher level of *OPTEXPENSE*, although it results in a larger negative impact on net income, might also yield higher signaling benefits.

All the variables described above are measured at the end of 2002. Because by that time more than 200 firms had already adopted ESO expensing, we also control for the percentage of firms within the same four-digit SIC that had decided to expense ESO by the end of 2002, *PEER_VOLEXP*. Finally, we control for industry effects (based on Core and Guay 1999).

Empirical Results

The univariate analyses in Table 4 are consistent with Predictions 1a and 1b. Firms targeted by an ESO expensing proposal are significantly more likely to subsequently announce their decision to voluntarily expense ESO than non-targeted firms in our S&P 500 control sample. Likewise, among the sub-sample of targeted firms receiving a vote, the proposal's approval (resulting from a majority of votes in favor) is associated with a significantly higher likelihood of expensing ESO. There was not a single case of adoption of ESO expensing among the firms in which the proposal was not approved. Hence, to test the effect of voting outcome (Prediction 1b) in the multivariate logit regression, we include the percentage of votes in favor of the proposal (*VOTESFOR*) rather a dummy variable denoting the proposal's approval.

Table 5 presents a multivariate analysis of Prediction 1. In Model 1, the coefficient on *TARGETED* is positive (+1.142) and statistically significant (p-value=0.001), consistent with Prediction 1a.²⁴ In terms of economic significance, this coefficient implies that the presence of a proposal is associated with an increase of 10.65 percentage points in the probability of subsequent adoption of ESO expensing, from 5.99 percent (when *TARGETED*=0) to 16.64 percent (when *TARGETED*=1).²⁵

[TABLE 4 and 5 APPROX. HERE]

²⁴ When we exclude the four firms for which it is unclear whether the proposal was submitted before the announcement of the decision to expense ESO, the coefficient on *TARGETED* becomes 1.019 (p-value = 0.003).

To partially address the concern that firms might have been targeted for reasons related to the likelihood of expensing ESO, we incorporate a correction for endogeneity using a two-stage approach. In the first stage, we predict the probability of being targeted using the model in Table 3. In the second stage, we use the predicted probabilities (*TARGETED_HAT*) in place of the *TARGETED* dummy. The sample size drops from 409 to 346 observations due to missing variables in the first stage. Our main result is confirmed: the coefficient on *TARGETED_HAT* remains positive (+5.379) and significant (p-value=0.045).

In Model 2, the coefficient on *VOTESFOR* is also positive (+21.21) and statistically significant (p-value=0.028), indicating a higher frequency of adoption among firms in which the proposal received higher voting support, consistent with Prediction 1b.²⁶

In Model 3 we examine the effect on non-targeted firms *only* when a peer firm is targeted by a proposal. The positive and significant coefficient on *PEER_TARGETED* (+0.70, with p-value=0.099) suggests a statistically higher likelihood of voluntary adoption of ESO expensing by non-targeted firms when peer firms are targeted, providing support for Prediction 1c. In terms of economic significance, the coefficient implies that the presence of a peer firm targeted by a proposal is associated with an increase of 2.76 percent in the probability of subsequent adoption of ESO expensing (from 2.87 percent when *PEER_TARGETED*=0 to 5.63 percent when *PEER_TARGETED*=1).²⁷

²⁵ We obtain this estimate assuming that all the independent variables other than *TARGETED* are equal to their sample means. If the independent variables are assumed to be equal to their sample median (rather than mean) values, the estimated increase in probability is 8.05 percent.

²⁶ When we use the voting outcome from 2003 rather than from 2004 for the firms targeted twice, the coefficient on *VOTESFOR* remains significant (+26.08, with a p-value = 0.038). This is not surprising because none of the firms targeted in both 2003 and 2004 announced the adoption of ESO expensing, except the firm (Safeway) that announced the decision to expense ESO few days before the 2004 vote (see notes to Table 2, Panel B).

²⁷ With respect to the control variables, it appears that firms issuing equity (*ISSUE*) are more likely to adopt ESO expensing, presumably to signal favorable prospects (Aboody et al. 2004). Notably, the percentage of peer firms already expensing options (*PEER_VOLEXP*) is significant in both Models 1 and 3, consistent with early adopters in 2002 leading firms in the same industry to follow suit in 2003 and 2004.

VI. Evidence of Whether Shareholder Proposals Affect CEO Compensation

Research Design

To examine whether ESO expensing proposals affect CEO pay practices at targeted firms (Prediction 2), we compare changes in the level and composition of CEO pay at targeted and S&P 500 control sample firms. We exclude firms hiring a new CEO to avoid the effect of one-time compensation choices (e.g., severance payments to outgoing CEOs, mega-grants to incoming CEOs). Also, firms targeted only in 2003 are not part of the control sample for 2004.

(a) Change in the level of CEO compensation

To test the impact of the ESO expensing proposals on the level of CEO compensation (Prediction 2a), we regress the change in CEO compensation ($\Delta LNCEOCOMP_{it}$), measured as the value of the natural logarithm of CEO total compensation²⁸ at firm i in fiscal year t minus the value in $t-1$, on a dummy indicating whether the firm was targeted by a proposal to be voted on in fiscal year $t-1$ ($TARGETED_{it-1}$) and a number of control variables.

$$\begin{aligned} \Delta LNCEOCOMP_{it} = & \alpha_0 + \alpha_1 TARGETED_{it-1} + \alpha_2 * \Delta ROA_{it} + \alpha_3 * RET_{it} + \alpha_4 * LNSIZE_{it-1} \\ & + \alpha_5 * MB_{it-1} + \alpha_6 * R \& D + \alpha_7 * CEOOWN_{it-1} + \varepsilon_{it} \end{aligned} \quad (2)$$

For a firm with fiscal year ending December 2002 and the vote taking place in April 2003, we measure compensation changes from 2003 (the year of the vote) to 2004. In doing so, we assume that changes in pay will be reflected in the year after the proposal is (or was supposed to be) voted upon. As a significant proportion of CEO pay is determined at the beginning of each fiscal year, changes are unlikely to occur until the following year (Core et al. 1999).

Previous research finds widespread evidence that performance measures, particularly stock price returns and earnings, are commonly used in compensation contracts (Lambert and Larcker

²⁸ Total compensation is defined as the sum of the CEO's salary, bonus, value of restricted stock granted, Black-Scholes value of options granted, long-term incentive payouts, and all other forms of annual compensation.

1987; Murphy 1999; Sloan 1993). We account for changes in performance by including controls for stock returns (*RET*) and changes in the return on assets (ΔROA). We also control for variables identified in prior studies as key determinants of executive pay: size (the natural logarithm of total assets, *LNSIZE*), market-to-book value of equity (*MB*), R&D expenditures (scaled by total assets, *R&D*), and CEO percentage ownership (*CEOOWN*). Many studies find that larger firms provide higher CEO compensation, consistent with the notion that these firms have higher monitoring costs and require more skilled managers (e.g., Gabaix and Landier 2008; Rosen 1982). Higher levels of executive pay have also been documented in firms with higher growth options and firms with more R&D (e.g., Cheng 2004; Smith and Watts 1992), perhaps because these firms require higher quality managers and make greater use of risky pay (requiring a higher risk premium). Finally, although greater CEO ownership might better align CEO interests with those of shareholders, resulting in lower compensation (Core et al. 1999), it might also enable CEOs to exercise more power in negotiating their compensation, resulting in higher pay. We do not have directional predictions for these variables because our dependent variable is defined in terms of changes rather than levels. Nonetheless, we include the level of these variables to allow for the possibility of an effect on changes in CEO pay (Baber et al. 1996). In robustness tests, we redefine these control variables in terms of their change over the year prior to the proposal.

(b) Change in the composition of CEO compensation

We test the impact of ESO expensing proposals on the weight assigned to ESO in the CEO compensation contract. This analysis is useful for two reasons. First, it helps us to understand whether the source of any change in compensation level is due to less use of ESO. Second, it allows for the possibility that ESO expensing proposals affected the composition of CEO pay, even if the level of total compensation was not affected.

We regress the variable $\Delta CEOOPTCOMP_{it}$ (the Black-Scholes value of the options granted to the CEO scaled by CEO total compensation in fiscal year t minus the value in fiscal year $t-1$) on the $TARGETED_{it-1}$ dummy and control variables:

$$\Delta CEOOPTCOMP_{it} = \beta_0 + \beta_1 TARGETED_{it-1} + \beta_2 * LNSIZE_{it-1} + \beta_3 * MB_{it-1} + \beta_4 * R \& D_{it-1} + \beta_5 * CEOOWN_{it-1} + \beta_6 * CASHSHORT_{it-1} + \beta_7 * STDRET_{it-1} + e_t \quad (3)$$

We include several control variables related to the use of stock options. Because stock option compensation might be used as a substitute for cash compensation in firms with cash constraints (Core and Guay 1999; Yermack 1995), we control for the degree of cash flow shortfall ($CASHSHORT$), calculated as [(common and preferred dividends + cash flows from investment – cash flows from operations) / total assets]. Monitoring is more difficult in firms operating in noisy environments (Yermack 1995), resulting in greater reliance on stock option compensation. On the other hand, managerial risk aversion implies that the use of stock options in the compensation package will increase at a decreasing rate relative to noise (Core and Guay 1999). We control for the effect of noise by using the natural logarithm of the standard deviation of a firm's monthly stock returns during the fiscal year $t-1$ ($STDRET$). Finally, as in regression (2), we control for $LNSIZE$, MB , $R\&D$, and $CEOOWN$. Firm size, growth, and R&D intensity are associated with higher monitoring costs, which lead to greater use of stock options. CEO ownership, on the other hand, is typically related to fewer agency conflicts resulting in less reliance on stock option compensation (Baber et al. 1996; Core and Guay 1999; Demsetz and Lehn 1985; Smith and Watts 1992; Yermack 2004). Again, we make no directional predictions for these control variables.

We use OLS regressions to test equations 2 and 3, and include all companies in fiscal years 2004 and 2005. We include firm random effects to mitigate serial correlation in residuals.

To test the effect of the voting outcome (Prediction 2b), we modify equations 2 and 3 as follows. First, we split the *TARGETED* dummy into two indicator variables, depending on whether a vote took place, *TARGETED_Vote* and *TARGETED_NoVote*. Then we further split the *TARGETED_Vote* dummy into two indicator variables, depending on whether the proposal was approved or not, *TARGETED_Approved* and *TARGETED_Not Approved*.

Empirical Results

The univariate analysis in Table 6, Panel A under “Proposal Effect” suggests that targeted firms reported a slight decrease in the average level of CEO pay ($\Delta CEOCOMP$) in the year after receiving the proposal. This contrasts with the increase observed for the S&P 500 control firms. However, this difference is statistically insignificant. Interestingly, a significantly higher proportion of targeted firms decided not to grant any options to their CEOs (dummy variable *NOCEOGRANT*).

When we restrict our analysis to firms in which the proposal was voted on (Table 6, Panel B), we observe a decrease in level of CEO compensation ($\Delta CEOCOMP$) and mix of options in CEO pay ($\Delta CEOOPTCOMP$) in firms in which the proposal was approved, vis-à-vis an increase in firms in which the proposal was not approved, although only the difference in $\Delta CEOOPTCOMP$ is statistically significant. In both Panel A and Panel B, there is no difference across sub-samples in terms of changes in the use of employee stock options at the firm-wide level in the year following an ESO expensing proposal (variable $\Delta TOTOPTIONS$).

[TABLES 6 and 7 APPROX. HERE]

Table 7, Panel A examines the effect of ESO expensing proposals on the change in level of CEO compensation in a multivariate setting. In Model 1 of Panel A, we examine the effect of a firm being targeted on the change in the natural logarithm of CEO compensation

($\Delta LNCEOCOMP$). Consistent with Prediction 2a, the coefficient on *TARGETED* is significantly negative (p-value=0.053).²⁹

Model 2 suggests that the result is driven by targeted firms in which a vote eventually took place (negative coefficient on *TARGETED_Vote*, p-value = 0.074). This raises the question of whether the effect depends on the voting outcome. The answer to this question is provided by Model 3. The significantly negative coefficient on *TARGETED_Approved* implies an average decrease in CEO pay of \$2.3 million in firms in which the proposal was approved relative to the control sample of non-targeted firms.³⁰

The coefficient on *TARGETED_Approved* is also significantly more negative than the coefficient on *TARGETED_NotApproved* (p-value=0.012, bottom of Panel A). This result suggests a lower change in CEO compensation in firms in which the proposal was approved, also relative to the firms in which the proposal was not approved, consistent with Prediction 2b.

Table 7, Panel B investigates the effect of ESO expensing proposals on the composition of CEO compensation, in particular, with respect to the change in the relative weight of ESO grants. In contrast to Prediction 2a, the results indicate an insignificant effect of being targeted (Model 1), regardless both of whether the proposal resulted in a vote at the annual meeting (Model 2) and the voting outcome (Model 3). However, the negative coefficient on *TARGETED_Approved*,

²⁹ To mitigate endogeneity concerns (e.g., firms targeted for reasons related to their compensation practices), as robustness test we use a two-stage approach: in the first stage we predict the probability of being targeted using the model in Table 3 (estimated separately for 2003 and 2004); in the second stage we use the predicted probabilities (*TARGETED_HAT*) in place of the *TARGETED* dummy. The sample size drops from 656 to 582 observations. The coefficient on *TARGETED_HAT* remains negative (-0.783) although its significance becomes weak (p-value=0.117).

³⁰ The -0.464 coefficient on *TARGETED_Approved* implies that the factor by which CEO pay increases (year-over-year) in a targeted firm in which the vote was approved is 62.9 percent ($e^{-0.464}$) of the factor by which CEO pay increases in non-targeted firms. To understand the economic significance of this result, consider that the median CEO pay in year t-1 is \$6,748,700 and the predicted $\Delta LNCEOCOMP$, holding all control variables at their mean values and setting all the *TARGETED* variables equal to zero, is 0.049. This means that in non-targeted firms CEO pay in year t was expected to be 105 percent (i.e., $e^{0.049}$) of CEO pay in year t-1 (i.e., an increase in CEO pay of \$337,000). The proposal approval (*TARGETED_Approved*=1) is associated with a decrease in the factor by which

although not significant (p-value=0.146), is significantly lower than the coefficient on *TARGETED_NotApproved* (see the test for difference in coefficients; p-value=0.026). In particular, holding all control variables (other than the *TARGETED_* variables) at their mean values, we find that the mix of ESO in CEO pay increased 3.2 percent in firms in which the proposal was not approved (*TARGETED_NotApproved=1* and *TARGETED_Approved=TARGETED_NoVote=0*), but decreased 7.8 percent in firms in which it was approved (*TARGETED_Approved=1* and *TARGETED_NotApproved=TARGETED_NoVote=0*). This shift away from ESO grants in CEO pay packages in firms in which the proposal was approved relative to firms in which it was not approved is consistent with Prediction 2b.

Robustness Tests

Prior studies suggest that shareholder proposals repeatedly submitted over many years might have a stronger impact on firms' governance practices, particularly in the case of a sequence of majority votes (Ertimur et al. 2008a). To investigate whether our findings in Panel A and Panel B are driven by firms targeted in both 2003 and 2004, we run our analyses with only the 2003 observations for these firms. The tenor of our key results (untabulated) is unchanged.

Prior studies also suggest that ESO expensing might have affected CEO pay practices.³¹ Hence, the CEO pay changes documented in Table 7 might be due to adoption of ESO expensing by some of the targeted firms rather than to the ESO expensing proposals. To explore this possibility, we add to our explanatory variables in Table 7 a dummy variable equal to 1 if the firm announced that it would voluntarily expense ESO in 2003 or 2004. Also, we split each of

CEO pay changes from 105 percent to 66 percent (i.e., 105 percent * 62.9 percent), resulting in a decrease in CEO pay of \$2.29 million.

³¹ Seethamraju and Zach (2003) provide some evidence that firms voluntarily adopting ESO expensing in the summer of 2002 in that same year reduced the number of options granted to their employees and their top five executives, both in absolute terms and relative to a control sample matched on industry and size. Brown and Lee (2007) document a significant reduction in the use of ESO in total compensation for top five executives as a result of

our variables of interest (e.g., *TARGETED* in Model 1) into two indicators, one for expensing and one for non-expensing firms (e.g., *TARGETED_Expense* and *TARGETED_No Expense*).

Untabulated tests yield the following insights. First, across the various models, the dummy for voluntary expensing has no effect on changes in levels of CEO pay (Panel A), but has a negative and significant effect (p-value <0.10) on the change in composition of CEO pay (Panel B). That is, firms voluntarily expensing ESO seem to reduce the weight of stock options in the CEO pay package. Second, and most important, all our results in Table 7 hold for the subset of targeted firms not expensing ESO. This means that our results are not driven by the subset of targeted firms expensing ESO. Third, the coefficients of interest for the subset of targeted firms expensing ESO are generally insignificant. A potential explanation is that targeted firms viewed the adoption of ESO expensing and changes in CEO compensation as substitute responses to the shareholder proposals and votes. However, these results should be interpreted with caution because some of the sub-samples (e.g., targeted firms in which the proposal was approved and ESO expensing adopted) become relatively small.

Finally, when we replicate Table 7 using changes rather than levels for the control variables (other than the performance measures), all results on the variables of interest are unchanged.

In summary, Table 7 documents a negative association between ESO expensing proposals and subsequent changes in CEO pay levels and use of options in CEO pay, the association being largely due to cases in which the proposal was approved by voting shareholders. These results are driven neither by the presence of firms targeted twice nor by the contemporaneous adoption of ESO expensing by some of the targeted firms. Our evidence contrasts with previous findings

mandatory ESO expensing (FAS123R), and show that such reduction resulted in a decrease in total compensation in firms with abnormally high executive compensation before FAS 123R.

of no significant consequences of pay-related shareholder proposals in the 1990s (Thomas and Martin 1999; Johnson and Shackell 1997).³²

VII. Conclusions

Over the 2003 and 2004 proxy seasons, a group of unions and other shareholder activists targeted more than 150 firms with a proposal requesting adoption of the fair value method of accounting for employee stock options (ESO), the first time the SEC allowed shareholder proposals on an accounting matter.

We assess the economic consequences of these proposals by analyzing their association with the likelihood of expensing ESO and with CEO compensation practices in the subsequent period. We find that the presence of a shareholder proposal was positively associated with the likelihood of adoption of ESO expensing not only by targeted firms but also by their peers in the same industry. Also, targeted firms in which the proposal was approved experienced decreases in both level of CEO compensation and relative use of ESO in CEO compensation.

Our study contributes to the accounting literature that relates shareholder behavior to accounting choices. We provide novel evidence of a direct mechanism, shareholder proposals, through which shareholders not only expressed their preference for an accounting method, but also seemed to successfully pressure firms to adopt this method, with spillover effects on non-targeted firms. Other accounting issues with social policy implications (e.g., accounting for pensions) might meet SEC requirements and become the subject of future shareholder proposals.

Our research also contributes to the literature on CEO pay. Unlike compensation-related shareholder proposals in the 1990s, we find that ESO expensing proposals often received

³² Because our tests focus on measures of realized compensation, they do not capture other important changes in compensation practices. For example, among the targeted firms, Intel decided to voluntarily submit its new stock option plan to shareholder approval every year (*Wall Street Journal* 2004) and Siebel Systems shifted to

significant voting support and, in these cases, were associated with subsequent changes in the level and composition of CEO pay. Our evidence calls for more research on the effectiveness of shareholder activism on CEO pay in the post-Enron period, characterized by closer scrutiny of CEO pay and new types of compensation-related shareholder proposals.

Finally, our work contributes to the growing literature on shareholder activism. Our evidence indicates greater influence of shareholder proposals on corporate decisions in the post-SOX environment, and highlights the need to account for spillover effects on non-targeted firms. Also, it suggests the possibility of a broader effect on the standard setting process. Shareholder proposals became a way to formalize investors' support for ESO expensing. In fact, SFAS No.123R explicitly refers to "numerous nonbinding shareholder resolutions" to expense ESO (SFAS No.123R, Appendix B, par.B26). Besides, by accelerating the rate of adoption of ESO expensing, these proposals affected the degree of comparability between voluntary adopters and other firms, one of the concerns leading to the issuance of the new standard (SFAS No.123R, Summary, par.B). In this respect, the ESO expensing initiative exemplifies the emerging role of shareholder proposals as a lobbying mechanism for influencing regulatory reform.³³ Our study might spur more research in this direction.

performance-based stock options (*Wall Street Journal* 2005). These changes might have been prompted, in part, by the ESO expensing proposals and ensuing debate.

³³ Two recent examples of union pension funds' initiatives also directed at influencing policy makers are the shareholder proposals asking firms to adopt a majority voting system for the election of directors (Sjostrom and Sang Kim 2007) and the shareholder proposals requesting that firms adopt an advisory vote on executive compensation reports (Ferri and Maber 2008).

Appendix 1: The “Path” Towards Employee Stock Option (ESO) Expensing

- **October 1995: SFAS 123**
 - FASB releases SFAS 123, allowing firms to choose between the fair value-based method and intrinsic value-based method of ESO accounting.
- **August 2001: IASB discussion paper**
 - IASB calls for comment on a discussion paper advocating ESO expensing.
- **February 2002-September 2002: support for ESO expensing builds**
 - Four Senators present a tax bill that would prohibit companies from deducting the cost of ESO from taxable income unless recognized as an expense (February).
 - In Standard & Poor’s new Core Earnings measure, ESO are expensed (May).
 - Coca Cola announces that it will begin expensing ESO (July).
 - TIAA-CREF and Council of Institutional Investors lobby firms to expense ESO (July).
 - Warren Buffett and Alan Greenspan advocate ESO expensing (July-August).
 - The Conference Board endorses ESO expensing (September).
- **September 2002-April 2003: regulators take action in favor of ESO expensing**
 - Securities and Exchange Commission (SEC)
 - Former SEC Chair H. Pitt states that shareholders should be given the opportunity to vote on whether to expense ESO (September 2002).
 - Reversing its prior position, the SEC allows shareholder proposals for ESO expensing to be voted on at annual meetings (December 2002).
 - Financial Accounting Standards Board (FASB)
 - FASB releases an invitation to comment on the IASB Exposure Draft on accounting for share-based payment (November 2002).
 - Accounting for stock-based compensation is put on the agenda (March 2003).
 - FASB determines that ESO should be expensed at fair value (April 2003).
- **February 2003-June 2003: support for ESO expensing grows**
 - Major accounting firms (E&Y, PWC) support ESO expensing (February-April 2003).
 - Sixty-nine shareholder proposals requesting ESO expensing are voted on, 30 of which receive a majority vote (April-June 2003).
 - By June 2003, ~300 U.S. firms have voluntarily adopted ESO expensing.
- **March 2003-December 2003: anti-expensing lobby takes initiative**
 - A bill introduced in Congress (H.R. 1372) would impose a three-year moratorium on any new related FASB rule (March 2003).
 - Seven thousand comment letters (1,800 from Cisco employees) are sent to FASB.
 - Senator Enzi (R-Wyo.) introduces a bill that would limit expensing to ESO granted to top five executives and exempt newly public firms for three years. A similar bill introduced by Senator Baker (R-La) would also postpone FASB’s release of a new rule (November).
- **February 2004-December 2004: standard setters mandate ESO expensing**
 - IASB issues a new standard (IFRS 2) mandating ESO expensing (February).
 - FASB issues an Exposure Draft requiring ESO expensing at grant date (March).
 - FASB releases SFAS 123R mandating ESO expensing at the grant date (December). By this time, ~800 U.S. firms have adopted ESO expensing.

Appendix 2: Excerpts of Proponents' Arguments for ESO Expensing Proposals

Intel Corp, Proxy Statement, 04/02/2003

The lack of option expensing can promote excessive use of options in a company's compensation plans, obscure and understate the cost of executive compensation and promote the pursuit of corporate strategies designed to promote short-term stock price rather than long-term corporate value.

A recent report issued by Standard & Poor's (2002) indicated that the expensing of stock option grant costs would have lowered operational earnings at companies by as much as 10 percent. "The failure to expense stock option grants has introduced a significant distortion in reported earnings," stated Federal Reserve Board Chairman Alan Greenspan. "Reporting stock options as expenses is a sensible and positive step toward a clearer and more precise accounting of a company's worth." *Globe and Mail*, "Expensing Options is a Bandwagon Worth Joining," Aug. 16, 2002.

Warren Buffett wrote in a *New York Times* Op-Ed piece on July 24, 2002:

There is a crisis of confidence today about corporate earnings reports and the credibility of chief executives. And it's justified. (...) I am referring to the legal, but improper, accounting methods used by chief executives to inflate reported earnings. Options are a huge cost for many corporations and a huge benefit to executives. (...) When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don't belong in the earnings statement, where in the world do they belong?

Many companies have responded to investors' concerns about their failure to expense stock options. In recent months, more than 100 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 more accurate financial statements. Our Company has yet to act. We urge your support.

Cintas Corp, Excerpt from Proxy Statement, 09/09/2003

...Standard & Poor's recently began calculating a "core earnings" number in which the cost of options is treated as an expense...

...We believe that voluntarily expensing stock options sends a signal to the market that a company is committed to transparency and corporate governance best practices.

...Expensing fixed stock option awards will also eliminate a disincentive to award indexed options, which tie compensation more closely to company rather than market or industry performance and which must be expensed. The Conference Board's Commission on Public Trust and Private Enterprise recently recommended that companies be required to expense fixed option awards in order to level the playing field among forms of equity-based compensation...

Delta Airlines, Excerpt from Proxy Statement, 03/25/2003

Stock options comprise an important part of Delta's executive compensation. From CEO Leo Mullin's hiring in August 1997 through the end of 2001, he was granted options to buy 1,693,200 shares of Delta stock, with an aggregate estimated value of \$45,918,859.

...not expensing stock options may lead to abuse by companies that see them as "free money." As Standard & Poor's put it in its recent report, "when something is significantly underpriced, it is often also substantially overconsumed." I believe this concern is relevant to Delta, since Institutional Shareholder Services, the largest proxy advisory service, has calculated that the total potential voting power dilution of Delta's equity compensation plan stands at 32.45 percent...

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TABLE 1
Sample Selection

Panel A: Primary Sample – Shareholder Proposals (Proxy Seasons 2003-2004)		
	<i>Number of Proposals</i>	<i>Number of Firms</i>
<i>Number of shareholder proposals on Option Expensing submitted</i> ¹	<i>153</i>	<i>131</i>
Less—Proposals withdrawn...		
...due to violation of technical requirements and others	19	19
...because the firm already had a policy of expensing ESO	<u>3</u>	<u>3</u>
<i>Valid shareholder proposals on Option Expensing submitted</i>	<i>131</i>	<i>109</i>
Less—Proposals withdrawn...		
... because the firm agreed to expense options ²	24	24
<i>Shareholder proposals voted upon at the annual meeting</i>	<u><i>107</i></u>	<u><i>85</i></u>
Panel B: Control Sample – S&P 500 Firms		
	<i>Number of Firms</i>	
<i>S&P 500 Firms as of December 2002, with data available in CRSP, Compustat, and Execucomp</i>	<i>477</i>	
Less—Targeted firms included in the S&P 500	<u><i>97</i></u>	
<i>Non-targeted S&P 500 firms</i>	<i>380</i>	
Less—Firms voluntarily expensing ESO ²	60	
<i>Control Sample</i>	<u><i>320</i></u>	

Notes:

¹ Firms are identified through a keyword search in the proxy statements of all firms registered at the SEC including the words “Proposal” and “Expensing” within a distance of six words. This search is complemented with a list of proposals submitted and then withdrawn (and, thus, never included in the proxy statements) provided by the United Brotherhood of Carpenters and Joiners of America (UBCJA) and from other online sources (www.thecorporatelibrary.com and www.georgesonshareholder.com).

² Firms are identified based on a list compiled by Bear Stearns & Co (Equity Research Report, December 16, 2004).

TABLE 2
Panel A: Shareholder Proposals and Voting Outcome – Summary Data

	Average across all proposals voted in		
	2003	2004	2003-2004
Number of Proposals	72	35	107
Voting Turnout (= votes cast as a % of votes eligible)	72.7%	72.0%	72.5%
Percentage of Proposals Approved ¹	41.7%	60.0%	47.7%
Voting outcome (% of all votes cast)			
Votes For	45.0%	50.9%	47.0%
Votes Against	51.6%	45.6%	49.6%
Abstentions	3.3%	3.5%	3.4%
	100%	100%	100%
Voting outcome (% of all votes cast excluding abstentions)			
Votes For	46.6%	52.6%	48.6%
Votes Against	53.4%	47.4%	51.4%
	100%	100%	100%
Voting outcome (% of all votes cast excluding abstentions and insider votes)²			
Votes For	55.0%	60.8%	56.9%
Votes Against	45.0%	39.2%	43.1%
	100%	100%	100%
Percentage of proposals voted, proposed by:			
Union pension funds ³	90.3%	88.6%	89.7%
Individuals	9.7%	11.4%	10.3%
	100%	100%	100%

Sources: Proxy Statements and 10Qs.

Notes:

¹ In some firms the approval rule called for votes FOR to exceed the sum of votes FOR, AGAINST, and ABSTAINING; in the other firms, it only required votes FOR to exceed votes AGAINST.

² In this calculation we assume all insiders voted against the proposal, as for all firms the proxy statements indicate that board and management opposed the proposals. Hence, we re-define:

% Votes For = Votes For / (Votes For + Votes Against – Insider Votes), and

% Votes Against = (Votes Against – Insider Votes) / (Votes For + Votes Against – Insider Votes).

³ We identify the following union pension funds among the sponsors of the proposals:

AFL-CIO Reserve Fund	American Federation of State, County and Municipal Employees Pension
Connecticut Retirement Plans	Central Laborers Pension, Welfare, & Annuity Funds
Culinary Workers Union Local 226	International Brotherhood of Electrical Workers' Pension Benefit Fund
Intl. Brotherhood of Teamsters	Sheet Metal Workers' International Association
Laborers Intl Union of North America	The Advisors' Inner Circle Fund/ United Assoc. S&P500 Index Fund
SEIU Master Trust	United Brotherhood of Carpenters and Joiners of America
Central Pension Fund of the Intl Union. of Operating Businesses and Participating Employees	
United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry	
Amalgamated Bank	

TABLE 2

Panel B: Voting Outcome for Firms with Shareholder Votes in 2003 and 2004

	Votes For as a Percentage of Votes Cast			Proposal Approval (1=Yes) (according to firm's approval rule)		
	2003	2004	Change	2003	2004	Change
Allegheny Energy Inc	39.7%	46.4%	6.6%	0	0	0
Allied Waste Industries Inc	41.1%	38.9%	-2.2%	0	0	0
American Finl Group Inc	20.6%	24.2%	3.6%	0	0	0
Cintas Corp	32.4%	34.5%	2.0%	0	0	0
Citrix Systems Inc	53.5%	68.8%	15.3%	1	1	0
Firstenergy	44.7%	53.2%	8.5%	0	1	1
Gillette Co	40.7%	41.1%	0.4%	0	0	0
Hewlett-Packard Co	43.4%	55.2%	11.8%	0	1	1
Intel Corp	47.6%	54.5%	6.9%	0	1	1
Intl Business Machine Corp	45.3%	51.5%	6.2%	0	1	1
Kinder Morgan Inc	30.6%	41.4%	10.7%	0	0	0
Mbna Corp	50.8%	56.5%	5.6%	1	1	0
Peoplesoft	46.7%	52.9%	6.3%	0	1	1
R.R. Donnelley & Sons Co	40.2%	53.3%	13.2%	0	1	1
Safeway Inc*	61.2%	50.7%	-10.6%	1	1	0
Siebel Systems Inc**	31.7%	49.1%	17.3%	0	0	0
Teco Energy Inc	45.8%	47.4%	1.6%	0	0	0
Unitedhealth Group Inc;	47.1%	51.5%	4.4%	0	1	1
Vectren Corp	42.5%	43.6%	1.1%	0	0	0
Wells Fargo & Co/Mn	56.3%	58.2%	1.9%	1	1	0
Weyerhaeuser Co	50.0%	62.4%	12.4%	1	1	0
Yahoo! Inc	33.7%	45.0%	11.4%	0	0	0
Average	43.0%	49.1%	6.1%	22.7%	54.5%	31.8%
	Number of firms experiencing...			% firms experiencing a switch to...		
	... an increase in voting support: 20			... approval if not approved in 2003: 41.2%		
	... a decrease in voting support: 2			...no approval if approved in 2003: 0.0%		

Note: * Safeway decided to voluntarily expense ESOs after being targeted for the second time but before the annual meeting (where a vote was taken nonetheless). This may explain the lower voting support in 2004.
 ** If abstention votes were not counted, in 2004 the proposal at Siebel would have been approved.

TABLE 3
Characteristics of Firms Targeted by an ESO Expensing Proposal
Logit Model Comparing the Targeted Sample with S&P 500 firms

Sample: [All targeted firms] + [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002], with available data in Compustat (financial variables), CRSP (stock returns), Execucomp (compensation and governance variables), Thomson Financial (institutional ownership), and the 10Ks or Bureau of Labor Statistics (union data).

	Expected	Dep. Variable=1 if Firm Targeted¹
Constant		1.101
<i>p-value</i>		(0.401)
<i>OPTCEO</i>	+	0.202
<i>p-value</i>		(0.065)
<i>OPTEXPENSE</i>	-	-11.22
<i>p-value</i>		(0.082)
<i>EXECOWN</i>	-	0.214
<i>p-value</i>		(0.960)
<i>INSTOWN</i>	+/-	-3.605
<i>p-value</i>		(<0.001)
<i>LNMVE</i>	+	-0.019
<i>p-value</i>		(0.564)
<i>MB</i>	-	0.011
<i>p-value</i>		(0.764)
<i>RETURNS</i>	-	-0.001
<i>p-value</i>		(0.498)
<i>LEVERAGE</i>	+	1.583
<i>p-value</i>		(0.028)
<i>EXECONBOARD</i>	-	-0.911
<i>p-value</i>		(0.128)
<i>HITECH</i>	+	0.576
<i>p-value</i>		(0.087)
<i>UNION</i>	+	0.002
<i>p-value</i>		(0.404)
<i>Pseudo R-square (N)</i>		7.4% (369)

Notes:

p-values in parentheses are one-tailed for directional predictions and two-tailed otherwise.

¹ All explanatory variables are measured at the beginning of 2003. The dependent variable is measured over the two-year window 2003-2004.

OPTCEO = number of options held by the CEO scaled by total shares outstanding.

OPTEXPENSE = Option expense (as disclosed in 10K footnotes under SFAS 123) scaled by market value of equity.

EXECOWN = Percentage of shares held by top five executives.

INSTOWN = Percentage of shares held by institutional investors.

LNMVE = Natural logarithm of market value of equity.

MB = Market-to-book value ratio.

RETURNS = Cumulative three year stock returns as of the end of 2002.

LEVERAGE = Total debt divided by total assets.

EXECONBOARD = Fraction of top five executives sitting on the board of directors.

HITECH = Dummy equal to 1 for firms in high tech industry, and 0 otherwise.

UNION = Fraction 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 Statistics).

TABLE 4
Effect of Option Expensing Proposals on Voluntary Adoption of Option Expensing
Univariate Analyses

			% Firms Announcing to Expense ESO in 2003-2004		<i>p</i> -values	
Variable	Sample	Sub-sample	Mean values	Difference in means	<i>t</i> -test	Wilcoxon test
Proposal Effect: Comparison of the frequency of adoption of ESO expensing between targeted and non-targeted firms	[All targeted firms] and [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002]	Targeted ¹	23.4%	14.2%	0.001	<0.001
		Not Targeted	9.2%			
Voting Outcome Effect: Comparison of the frequency of adoption of ESO expensing between firms in which the proposal was approved and firms in which it was not approved	Only targeted firms in which the proposal was voted upon	Approved	15.2%	15.2%	0.007	0.012
		Not Approved	0%			

Notes:

p-values are two tailed.

¹ The targeted sample includes three firms that expensed ESO at the end of 2002 (rather than in 2003-2004) because they were targeted by a proposal for the proxy season of 2003 (i.e., a proposal that would be voted upon in 2003).

TABLE 5

Effect of Option Expensing Proposals on Voluntary Adoption of Option Expensing Logit Model Comparing Targeted firms with S&P 500 firms

(Dep. Var.= 1 if firm announced to voluntarily expense options in 2003 or 2004, 0 otherwise)²

Sample: [All targeted firms] + [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002], with available data in Compustat (financial variables), Execucomp (compensation and governance variables), Thomson Financial (institutional ownership), and Security Data Corporation (acquisitions and equity issuance). Relative to the main sample used in Model 1 and described above, Model 2 includes only targeted firms receiving a vote, and Model 3 excludes all firms targeted by an ESO expensing proposal.

	Expected	Model 1	Model 2	Model 3
Constant		-3.868	-0.559	-3.994
<i>p-value</i>		(0.050)	(0.938)	(0.202)
<i>TARGETED</i>	+	1.142		
<i>p-value</i>		(0.001)		
<i>VOTESFOR</i>	+		21.21	
<i>p-value</i>			(0.028)	
<i>PEER_TARGETED</i>	+			0.700
<i>p-value</i>				(0.099)
Control Variables:				
<i>PEER_VOLEXP</i>	+	5.104	-52.22	5.862
<i>p-value</i>		(0.066)	(0.898)	(0.098)
<i>INSTOWN</i>	-	-1.189	-7.891	-1.104
<i>p-value</i>		(0.168)	(0.102)	(0.294)
<i>ISSUE</i>	+	0.939	1.226	0.827
<i>p-value</i>		(0.007)	(0.226)	(0.086)
<i>ACQ</i>	+	-0.267	0.402	0.434
<i>p-value</i>		(0.749)	(0.423)	(0.233)
<i>DEBTEQ</i>	+	0.064	1.953	0.101
<i>p-value</i>		(0.286)	(0.057)	(0.250)
<i>INTCOV</i>	+	-0.0002	-0.002	-0.0003
<i>p-value</i>		(0.914)	(0.954)	(0.920)
<i>BONUS</i>	-	-0.208	2.974	-1.591
<i>p-value</i>		(0.380)	(0.778)	(0.056)
<i>CEOOWN</i>	+	-18.53	-14.92	-12.35
<i>p-value</i>		(0.992)	(0.651)	(0.913)
<i>ODIRGRANT</i>	+	605.8	8435	-20980
<i>p-value</i>		(0.400)	(0.226)	(0.957)
<i>LNMVE</i>	+	0.276	-0.780	0.181
<i>p-value</i>		(0.050)	(0.880)	(0.250)
<i>PROFIT</i>	+	-0.097	15.82	-1.644
<i>p-value</i>		(0.560)	(0.220)	(0.874)
<i>OPTTOP5</i>	+	-0.199	-7.436	0.639
<i>p-value</i>		(0.570)	(0.812)	(0.340)
<i>OPTEXPENSE</i>	+/-	1.382	-113.5	-16.28
<i>p-value</i>		(0.902)	(0.235)	(0.564)
<i>Industry Dummies</i> ¹		Yes	No	Yes
<i>Pseudo R-square (N)</i>		21.0% (409)	50.2% (83)	25.6% (284)

Notes:

p-values in parentheses are one-tailed for directional predictions and two-tailed otherwise.

¹The model includes indicator variables denoting the firm's industry membership based on the industry classification in Core and Guay (1999). The industry-specific intercepts are untabulated.

² The targeted sample includes three firms that expensed ESO at the end of 2002 (rather than in 2003-2004) because they were targeted by a proposal for the proxy season of 2003 (i.e., a proposal that would be voted upon in 2003).

Both the dependent and the independent variables of interest are measured over the two-year window 2003-2004. The control variables are measured as of the end of 2002.

TARGETED = Dummy equal to 1 if the firm was targeted by an ESO expensing proposal in the proxy season of 2003-2004.

VOTESFOR = Votes in favor divided by the sum of votes in favor and votes against the ESO expensing proposal.

PEER_TARGETED = Dummy equal to 1 if at least one firm with the same SIC four-digit code was previously targeted by an ESO expensing proposal.

PEER_VOLEXP = Percentage of firms with the same SIC four-digit code that had already announced their intention to expense ESO by the end of 2002.

ISSUE = Indicator variable equal to 1 if the firm issued equity during the last three fiscal years, and 0 otherwise.

ACQ = Indicator variable equal to 1 if the firm used equity to acquire another firm during the last three fiscal years, and 0 otherwise.

DEBTEQ = Ratio of long-term debt to shareholder's equity.

INTCOV = Rank variable based on the firm's ratio of interest expense to operating income. Lower levels indicate better coverage and higher levels indicate lower coverage. Cases in which the ratio is negative (due to negative operating income) are given the highest ranking score.

BONUS = Ratio of CEO cash bonus to total cash compensation.

CEOOWN = Equity shares and options held by the CEO as a percentage of shares outstanding.

ODIRGRANT = Equity shares and options granted to outside directors as a percentage of shares outstanding.

INSTOWN = Percentage of shares outstanding held by institutional investors.

LN MVE = Logarithm of year-end market value of equity.

PROFIT = Net income deflated by market value of equity.

OPTTOP5 = Fraction of total options granted in a given year which is granted to the top five executives.

OPTEXPENSE = Option expense (as disclosed in 10K footnotes under SFAS 123) scaled by market value of equity.

TABLE 6
Univariate Analysis : Effect of Option Expensing Proposals on Compensation¹

Sample: [All targeted firms] + [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002]. Panel B restricts the sample to the sub-sample of targeted firms.

Panel A: Proposal Effect

Comparison of changes in compensation between targeted and non-targeted firms

Variable	Difference in means			<i>p</i> -values	
	Targeted	Not Targeted	Difference	<i>t</i> -test	Wilcoxon test
$\Delta CEOCOMP$	-75.7	523	-599	0.687	0.607
$\Delta CEOOPTCOMP$	-0.033	-0.035	0.002	0.949	0.674
$\Delta CEOOPTMVE$	-0.077	-0.064	-0.013	0.836	0.94
$\Delta TOTOPTIONS$	-0.003	-0.003	0	0.806	0.948
$NOCEOGRANT$	0.293	0.212	0.081	0.053	0.053

Panel B: Voting Outcome Effect

Comparison of changes in compensation between targeted firms in which the vote was approved and targeted firms in which the vote was not approved

Variable	Difference in means			<i>p</i> -values	
	Approved	Not Approved	Difference	<i>t</i> -test	Wilcoxon test
$\Delta CEOCOMP$	-1602	1792	-3394	0.411	0.566
$\Delta CEOOPTCOMP$	-0.084	0.0321	-0.116	0.069	0.079
$\Delta CEOOPTMVE$	-0.131	0.008	-0.139	0.365	0.371
$\Delta TOTOPTIONS$	-0.003	-0.001	-0.002	0.578	0.486
$NOCEOGRANT$	0.267	0.286	-0.019	0.845	0.848

Notes:

¹ We analyze the effects of the 2003 and 2004 proposals on changes in compensation occurring the year after the firm was targeted. In Panel B we focus on the sub-sample of targeted firms and analyze the effect of the voting outcome of the proposal on changes in compensation in the year after the vote took place.

$CEOCOMP$ = CEO Total compensation including salary, bonus, value of restricted stock granted, Black-Scholes value of options granted, long-term incentive payouts, and all other forms of annual compensation (item TDC1 in the Execucomp database).

$CEOOPTCOMP$ = Black-Scholes value of total options granted to the CEO divided by $CEOCOMP$.

$CEOOPTMVE$ = Black-Scholes value of total options granted to the CEO divided by market value of equity.

$TOTOPTIONS$ = Number of options granted by the firm to all employees during the year divided by shares outstanding.

$\Delta CEOCOMP$, $\Delta CEOOPTCOMP$, $\Delta CEOOPTMVE$, $\Delta TOTOPTIONS$ = Value of $CEOCOMP$, $LNCEOCOMP$, $CEOOPTCOMP$, $CEOOPTMVE$, and $TOTOPTIONS$ in fiscal year t minus the value in fiscal year $t-1$.

$NOCEOGRANT$ = Dummy equal to 1 if the CEO did not receive an option grant in the fiscal year after the firm was targeted, and 0 otherwise.

TABLE 7
Multivariate Analysis : Effect of Option Expensing Proposals on CEO Compensation¹
Panel A: Effect on Level of CEO Compensation

$$\Delta LNCECOMP_{it} = \alpha_0 + \alpha_1 TARGETED_{it-1} + \alpha_2 * \Delta ROA_{it} + \alpha_3 * RET_{it} + \alpha_4 * LNSIZE_{it-1} \\ + \alpha_5 * MB_{it-1} + \alpha_6 * R \& D_{it-1} + \alpha_7 * CEOOWN_{it-1} + \varepsilon_{it}$$

Sample: [All targeted firms] + [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002], with available data in Compustat (financial variables), CRSP (stock returns), Execucomp (compensation and ownership variables).

		<i>ΔLNCECOMP</i>		
	Expected	Model 1	Model 2	Model 3
<i>Intercept</i>		0.403 (0.502)	0.404 (0.502)	0.333 (0.578)
<i>TARGETED</i>	-	-0.198 (0.053)		-0.165 (0.209)
<i>TARGETED_NoVote</i>	-		-0.183 (0.186)	
<i>TARGETED_Vote</i>	-		-0.205 (0.074)	
<i>TARGETED_NotApproved</i>	+/-			0.080 (0.674)
<i>TARGETED_Approved</i>	-			-0.464 (0.006)
Control Variables:				
<i>ΔROA</i>	+	2.281 (0.002)	2.284 (0.002)	2.213 (0.002)
<i>RET</i>	+	0.172 (0.132)	0.172 (0.132)	0.212 (0.086)
<i>LNSIZE</i>	+/-	0.002 (0.974)	0.001 (0.976)	0.009 (0.855)
<i>MB</i>	+/-	0.002 (0.311)	0.002 (0.312)	0.002 (0.299)
<i>R&D</i>	+/-	-1.091 (0.460)	-1.094 (0.459)	-0.964 (0.512)
<i>CEOOWN</i>	+/-	0.651 (0.673)	0.660 (0.670)	0.276 (0.859)
<i>Industry Dummies²</i>		Yes	Yes	Yes
<i>Number of observations</i>		656	656	656
<i>Number of firms</i>		414	414	414
<i>R-squared</i>		7.6%	7.6%	8.5%

	Differences in Coefficients	chi-squared	p-value
Model 2	Targeted_Voted = Targeted_NotVoted	0.01	(0.923)
Model 3	Targeted_Approved < Targeted_NotApproved	5.06	(0.012)

p-values in parentheses are one-tailed for directional predictions and two-tailed otherwise.

TABLE 7
Multivariate Analysis : Effect of Option Expensing Proposals on CEO Compensation¹
Panel B: Effect on Composition of CEO Compensation

$$\Delta CEOOPTCOMP_{it} = \beta_0 + \beta_1 TARGETED_{it-1} + \beta_2 * LNSIZE_{it-1} + \beta_3 * MB_{it-1} + \beta_4 * R \& D_{it-1} + \beta_5 * CEOOWN_{it-1} + \beta_6 * CASHSHORT_{it-1} + \beta_7 * STDRET_{it-1} + e_t$$

Sample: [All targeted firms] + [all non-targeted S&P 500 firms that were not voluntarily expensing ESO as of the end of 2002], with available data in Compustat (financial variables), CRSP (stock returns), Execucomp (compensation and ownership variables).

		$\Delta CEOOPTCOMP$		
	Expected	Model 1	Model 2	Model 3
<i>Intercept</i>	+/-	0.118 (0.421)	0.118 (0.425)	0.110 (0.454)
<i>TARGETED</i>	-	0.003 (0.552)		
<i>TARGETED_NoVote</i>	-		-0.013 (0.395)	-0.009 (0.423)
<i>TARGETED_Vote</i>	-		0.009 (0.622)	
<i>TARGETED_NotApproved</i>	+/-			0.067 (0.115)
<i>TARGETED_Approved</i>	-			-0.043 (0.146)
Control Variables:				
<i>LNSIZE</i>	+/-	-0.010 (0.349)	-0.010 (0.351)	-0.008 (0.414)
<i>MB</i>	+/-	-0.0001 (0.827)	-0.0001 (0.829)	-0.0001 (0.836)
<i>R&D</i>	+/-	-0.078 (0.809)	-0.074 (0.818)	-0.050 (0.875)
<i>CEOOWN</i>	+/-	-0.179 (0.580)	-0.185 (0.567)	-0.252 (0.438)
<i>CASHSHORT</i>	+/-	0.021 (0.812)	0.023 (0.797)	0.027 (0.764)
<i>STDRET</i>	+/-	-0.021 (0.392)	-0.021 (0.383)	-0.022 (0.368)
<i>Industry Dummies²</i>		Yes	Yes	Yes
<i>Number of observations</i>		648	648	648
<i>Number of firms</i>		410	410	410
<i>R-squared</i>		3.0%	3.1%	3.6%

	Differences in Coefficients	chi-squared	p-value
Model 2	Targeted_Voted = Targeted_NotVoted	0.17	(0.680)
Model 3	Targeted_Approved < Targeted_NotApproved	3.78	(0.026)

p-values in parentheses are one-tailed for directional predictions and two-tailed otherwise.

Notes:

¹ We analyze the effects of the 2003 and 2004 proposals on the changes in compensation practices occurring the year after the firm was targeted.

² The model includes indicator variables denoting the firm's industry membership based on the industry classification in Core and Guay (1999). The industry-specific intercepts are untabulated.

CEOCOMP = CEO Total compensation including salary, bonus, value of restricted stock granted, Black-Scholes value of options granted, long-term incentive payouts, and all other forms of annual compensation (item TDC1 in the Execucomp database).

LNCEOCOMP = Natural logarithm of *CEOCOMP*.

CEOOPTCOMP = Black-Scholes value of total options granted to the CEO divided by *CEOCOMP*.

Δ *CEOCOMP*, Δ *LNCEOCOMP*, Δ *CEOOPTCOMP* = Value of *CEOCOMP*, *LNCEOCOMP*, and *CEOOPTCOMP* in fiscal year *t* minus the value in fiscal year *t-1*.

TARGETED = Dummy equal to 1 if firm was targeted for a proposal, and 0 otherwise, during fiscal year *t-1*.

TARGETED_Vote = Dummy equal to 1 if firm was targeted in fiscal year *t-1* and the proposal was voted upon, and 0 otherwise.

TARGETED_NoVote = Dummy equal to 1 if firm was targeted in fiscal year *t-1* but the proposal was withdrawn, and 0 otherwise.

TARGETED_Approved = Dummy equal to 1 if firm was targeted in fiscal year *t-1* and the proposal was approved, and 0 otherwise.

TARGETED_NotApproved = Dummy equal to 1 if firm was targeted in fiscal year *t-1* and the proposal was not approved, and 0 otherwise.

APPROVED = Dummy equal to 1 if the proposal was approved in fiscal year *t-1*, and 0 otherwise.

VOTESFOR = Votes in favor divided by the sum of votes in favor and votes against the ESO expensing proposal.

ROA = Income before extraordinary items divided by total assets | Δ *ROA* = *ROA* in fiscal year *t* minus *ROA* in fiscal year *t-1*.

RET = Annual stock returns.

SIZE = Total assets (\$MM) | *LNSIZE* = Natural logarithm of *SIZE*.

MB = Market-to-book value ratio.

CEOOWN = Equity shares and options held by the CEO as a percentage of shares outstanding.

CASHSHORT = Cash shortage measured as [(common and preferred dividends + cash flows from investment – cash flows from operations) / total assets].

STDRET = Natural logarithm of the standard deviation of the firm's monthly stock returns over the fiscal year.