This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Selling Insiders Lead Us to Other Concerns
Walgreen Company (NYSE:WAG)

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Walgreen Company is a drugstore chain in the United States with stores located in 43 states and Puerto Rico. As of August 31, 2002, the Company had 3,880 retail drugstores and three mail service facilities. Its drugstores are engaged in the retail sale of prescription and non-prescription drugs and carry additional product lines, such as general merchandise, cosmetics, toiletries, household items, food and beverages. Customer prescription purchases can be made at the drugstores, as well as through mail, by telephone and on the Internet. Prescription sales continue to become a larger portion of the Company's business.

Summary of 3DAdvisors Findings for WAG

- **Insider Trading:** Concentration of selling gets our attention
- **Accounting:** Booking tax benefit before options are exercised
- **Governance:** Disclosure behavior is troubling
- **Insider Trading:** April selling pattern is repeated in May

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Discussion of 3DAdvisors Findings

Insider Trading: Concentration of selling gets our attention

Walgreen is a textbook example of insider trading activity leading us to interesting accounting and governance issues.

Our attention was initially drawn by a very interesting concentration of insider sales at WAG that occurred on April 4th (Friday) as the shares rallied from their $30 level to $32. This was right about the time that the overall market rallied as it became apparent that the conflict in Iraq was going to be short-lived. On that day, six insiders unloaded a total of 120,784 shares, mostly at prices right around $32 each.

One fact that gets our attention here is that the six have never been regular sellers, nor have they ever converged to sell in anything close to such a narrow window of just one day, or even one month for that matter. Another fact that really caught our eye is that the rally in Walgreen shares (that they sold into) had weak legs and the shares were back down to the $29 to $30 level by month's end.

The sellers:

George Eilers (62) - Senior V.P. Eilers dropped 15,432 shares. His last sale was in January of 2002 (13,703 shares), prior to that he sold in June of 2001 (15,632 shares) and prior to that, he sold in October of 2000 (23,680 shares).

Jerome Karlin (60) - Executive V.P. Karlin sold 27,776 shares. His last sale, in February of 2002, totaled 25,792 shares, and prior to that, in October of 2000, he sold 41,464 shares.

Randy Lewis (52) - Senior V.P. Lewis cleared out of 11,832 shares. Prior to this he had not been seen selling since October of 1998.

Julian Oettinger (63) - General Counsel. Oettinger sold 27,008 shares. His last sale was August 2002 (25,016 shares), prior to that was January 2002 (25,256 shares) and prior to that August 2000 (8,900 shares).

Roger Polark (54) - CFO. Polark sold 4,016, his next prior sale was March 2002 (5,353 shares), prior to that March 2001 (14,320 shares), and prior to that September 2000 (5,791 shares).

William Shiel (51) - Senior V.P. Shiel sold 34,720 shares. His most recent prior sale took place in January 2002 (32,048 shares), and prior to that, September 2000 (30,350 shares).

<u>Accounting: Booking tax benefit before options are exercised</u>

The above concentration of selling caused us to look into Walgreen's option plans, and there are a number of areas involving these programs where a certain amount of obfuscation exists. Company behavior, in this regard, is somewhat suspect as it is not clear why certain items are reported in such an unorthodox manner. In addition, how they are accounting for option exercises is highly unusual, so the options situation at WAG is both a governance as well as accounting story to us.

The first thing we noticed when looking at the structure of Walgreen's stock option plans was that the majority of them had been issued without shareholder approval. Of over 34 million outstanding options (as of the 10K for Y/E 8/31/02), 19.8 million had been issued without approval. Walgreen was able to circumvent the approval process because the related plans fit the requirements for being "Broad Based" and thus are exempt from requiring shareholder approval. These broad based plans became popular in '00 when the SEC and NASD eased the requirements for shareholder approval, providing the plan included a broad enough cross section of employee participation. The popularity of these non-shareholder-approved plans has since waned however, since shareholders' rights organizations have been more than vocal in their opposition to a process that circumvents the shareholder approval process.

Walgreen's first broad-based plan was issued in '00, when the idea was very much in vogue. Walgreens issued a much larger broad-based plan in Sept. of '02 even though the popularity of these plans was well past their peak. It looks as if Walgreen's adoption of a broad-based plan last September was certainly not applauded by shareholder rights groups. The earlier plan (initiated in '00) covered 14.8 million shares in total. Options under the Sept. '02 plan can be granted until September of 2012 and can total up to 42 million shares.

Now these plans are creating some significant tax benefits at the company. Additionally, and more significantly, it seems that Walgreen has found a way to book some of the tax savings earlier than what would normally be the case. Companies typically book the tax benefit from options at the time of their exercise. The actual tax savings from the exercise, plus the cash coming in from the transaction, show up as cash inflows in the Cash Flow Statement and are booked as credits to Paid in Capital. Walgreen had been no different in this regard. Until Q1 of 2003, that is. It was in Q1 that, instead of a cash inflow (related to stock option exercises), a $41 million outflow appeared. Paid in capital, which had been going up sequentially in each year (with the vast majority of each year's increase consistently related to employee stock plans), suddenly took a $23 million dip in Q1 2003. The process continued in Q2 (but not at the same pace) as employee stock plans caused another cash outflow, this time for $5.8 million. Paid-in Capital moved lower as well, dropping another $9 million.

This reduction in paid-in capital, coupled with same period outflows in Cash Flow (related to the tax benefit from options) is a signal that they were forced to unwind some of their previously booked tax benefits when it became apparent that they would no longer be used. This tells us that Walgreen has found a way to book some of its tax benefits in advance of their actual exercise of the options, as opposed to at the time of the exercise. As Walgreen shares dropped, however, and some of the anticipated options exercises did not occur, it seems that the company was forced to back-out some of the previously recorded benefits, hence the reductions in paid-in capital.

Adding spice to the story is the terse, one-time mention, in the Q2 "Q" notes (Financial Condition) that "This fiscal year we have purchased stock on the open market to satisfy the requirements of various stock purchase and options plans as opposed to last fiscal year when stock was principally issued from unissued shares." Walgreen never quantified how many shares were bought, or how much was spent. In addition, the Cash Flow statement contains no entry for cash outflow for share repurchases. Instead, it seems that they have quietly netted the Cash from Employee Stock Exercises with what was spent for repurchases (plus, we suspect, the effect of backing-out some previously booked but unused tax benefit) making any breakout of the items impossible.

Now we all know that companies usually jump at the chance to say they are repurchasing stock. Walgreen however, did not even disclose that it had bought shares in Q1, when it seems that most of the activity occurred. It wasn't until Q2 when the item was briefly mentioned in the notes that there was any disclosure at all.

Another interesting point to all of this is the fact that Walgreen has been steadily building a deferred tax asset related to these employee benefit plans. At the time of the '02 10K (August 31), this asset was $106 million. This becomes much more interesting if further under-performance of Walgreen shares results in further reductions of the previously-expected level of stock option exercises. If the Company has been pre-booking some of the tax benefit (as we suspect), it is very possible that a significant portion of this $106 million deferred tax asset will not be utilized, and may be in jeopardy.

Governance: Disclosure behavior is troubling

The trend at WAG seems to be towards more complete disclosure of certain items, probably at the insistence of their auditors (Deloitte & Touche), but the pattern is nonetheless troubling. The path of disclosure is interesting in that each quarter, a little more comes out. In another example, take a look at how long it took them to completely disclose their off-balance sheet arrangements. They have just begun (as of their most recent "Q" filed in early April) to disclose the details of off balance sheet items. We were very surprised to see that, in this new push towards “transparent” disclosure, Walgreen had not done so before, even in its most recent 10K for F/Y ending 8/31/2002. Only on the subsequent Q1 10Q (F/Y ’03 period ending 11/30/2002) did they include (for the first time) any information of this nature. This change in disclosure coincides with changing auditors from Arthur Andersen to Deloitte & Touche. The strange thing is that the first "K" filing under the Touche appointment did not include any section relating to Contractual Obligations and Commitments (read: off balance sheet disclosure). Take a look at the progression of such disclosures in the following two Walgreen 10Q’s (Q1, 2003 and Q2, 2003). It looks as if the Company is acquiescing to increasing pressure to disclose more:

Table 1. Contractual Obligations and Commitments as of 11/30/02
Source: Walgreen Company FY 2003 Q1 SEC Form 10-Q

	Payment Due (In Millions)		
Obligation	Total	Less Than 1 Year	More Than 1 Year
Operating Leases*	$15,721.1	$907.1	$14,814.0
Closed Locations	98.7	23.1	75.6
Other Long Term Obligations	21.6	7.0	14.6
Short Term Borrowings	-	-	-
Total	$15,841.4	$937.2	$14,904.2

* Not on balance sheet

What are missing are real estate development commitments of $223.8 million, as well as letters of credit totaling $104.9 million, which guarantee foreign trade purchases and payments of casualty claims. They are not mentioned anywhere, until they are disclosed in the next 10-Q filing, along with a number of other items:

Table 2. Contractual Obligations and Commitments as of 2/28/03
Source: Walgreen FY 2003 Q2 SEC Form 10-Q

	Payment Due (in Millions)		
Contractual Obligations	Total	Less Than 1 Year	More Than 1 Year
Operating Leases*	$ 16,245.9	$ 925.5	$ 15,320.4
Purchase Obligations:			
Open Inventory Purchase Orders*	802.8	802.8	-
Real Estate Development*	220.5	220.5	-
Other Corporate Obligations*	56.9	25.7	31.2
Insurance	278.1	132.4	145.7
Retiree Health & Life	146.2	6.3	139.9
Closed Location Obligations	88.7	22.2	66.5
Long-Term Debt	13.9	4.6	9.3
Capital Lease Obligations	6.5	1.5	5.0
Other Long-Term Liabilities Reflected on the Balance Sheet	185.3	14.7	170.6
Total	$ 18,044.8	$ 2,156.2	$ 15,888.6

* Not on balance sheet

One can make the case for this increasing disclosure of these off-balance sheet items as something to be expected in the post-Enron environment. The progression of the disclosure however, from Q to Q without having even been mentioned in the previous 10K seemed rather interesting to us, especially in light of the fact that, at the same time, disclosure progression was taking the opposite direction, becoming murkier, in the area of stock options exercises and associated tax benefits. We wonder if there may not be more to come.

Insider Trading: April selling pattern is repeated in May

The entire traunche of the earlier broad-based options, 14.8 million shares exercisable at $29.1875 each, became exercisable on Monday, May 11th. It's interesting that we have such a pickup of insider selling prior to the exercisable date and just after the soon-to-be-exercisable options moved from underwater to above the strike price. Indeed, insider selling has continued in May since we first noticed the selling in April (mentioned above). Since the earlier selling in April, which we characterized as a convergence of insider distribution into a short-lived rally in Walgreen shares, the following have surfaced:

David Bernauer (58) - Chairman. Bernauer sold 28,552 shares at $33.08 in early May. If asked about the sale, we'd bet he'd tell you that he exercised options that were expiring. This would be factual, as the options are set to expire on 9/1/2003. This would not explain, however, the fact that he chose to sell the entire amount of shares optioned for (something we haven't seen him do since May of 2001). With an option strike price of under $5, he could have easily turned in a few shares, in payment for the strike price and associated taxes, and kept the rest.

William Shiel (51) - Senior V.P. Shiel followed up his 34,720 early April sale (mentioned above) with a larger one of just over 51,000 shares in the $33 range. This time, Shiel cleared out his entire traunche of $4.70 options, which were not expiring until September of 2004. His sale came on the same day (May 8) as Bernauer's.

Chester Young (57) - General Auditor. Young sold 12,000 for $32.96 each. Young appears to be a new filer. In selling the shares, on May 7th, he exercised his entire position of the same options that Shiel (above) had. The options do not expire until September of 2004.

Another accompaniment to these sales is the fact that all three sold at the top of an 11% rally in the shares (from below $30 to just above $33). The rally didn't make it, as Walgreen shares dropped sharply back to the $30 level on the heels of the release of the Company's Q3 earnings release (June 23rd). This, you may recall, is very reminiscent of the early April selling, described above, where insiders sold similarly into a rally that petered out as well.

Add these to the previous list and you have one of the most interesting convergences of sellers at the company that we've seen.