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COOPER INDUSTRIES, LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed Fair value is determined by estimating the present value of future cash flows The second step compares the implied fair value of reporting unit goodwill to the carrying amount of the goodwill to measure the amount of impairment loss See Note 6 of the Notes to the Consolidated Financial Statements

Revenue Recognition: Cooper recognizes revenues when products are shipped Accruals for sales returns and other allowances are provided at the time of shipment based upon experience The accrual for sales returns and other allowances was $45 6 million and $33 8 million at December 31, 2004 and 2003, respectively Shipping and handling costs of $132 2 million, $117 1 million and $118 9 million in 2004, 2003 and 2002, respectively, are reported as a reduction of revenues in the consolidated income statements

Research and Development Expenditures: Research and development expenditures are charged to earnings as incurred Research and development expenses were $70 6 million, $63 4 million and $54 0 million in 2004, 2003 and 2002, respectively

Stock-Based Compensation: Effective January 1, 2003, Cooper adopted Statement of Financial Accounting Standards No 123, *Accounting for Stock-Based Compensation* ("SFAS No 123"), as amended Cooper's stock- based compensation plans are described in Note 10 of the Notes to the Consolidated Financial Statements Cooper utilized the prospective method of adoption Cooper accounted for stock-based compensation awards granted, modified or settled prior to January 1, 2003 using the intrinsic value method of accounting as prescribed by Accounting Principles Board Opinion No 25, *Accounting for Stock Issued to Employees* and related interpretations ("APB No 25") In accordance with APB No 25, compensation expense was recognized for performance-based and restricted stock awards No compensation expense was recognized under Cooper's fixed stock option plans or Employee Stock Purchase Plan for grants prior to January 1, 2003

SFAS No 123 provides an alternative fair value based method for recognizing stock-based compensation in which compensation expense is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period The fair value of stock options is estimated on the grant date, using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2004, 2003 and 2002 respectively dividend yield of 2 5%, 3 8% and 3 9%, expected volatility of 34 0%, 34 0% and 33 0%, risk free interest rates of 3 1%, 2 7% and 4 8% and expected lives of 5 years in 2004, 4 years in 2003 and 7 years for 2002 The fair value of restricted stock and performance-based awards granted in 2004 and 2003 was measured at the market price on the grant date Total stock-based compensation expense was $22 1 million in 2004 and $10 5 million in 2003 Previously accrued stock-based compensation of $1 7 million related to performance based awards was reversed to income during 2002 as it was determined that certain performance targets would not be met

The following table presents pro forma net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each year