March 17, 1997

New Earnings per Share Accounting Standard May Shed More Sunlight on Stock-Based Compensation

As anticipated, the Financial Accounting Standards Board (FASB) issued on March 3 a final new standard governing the calculation and disclosure of earnings per share (EPS).(1) The new standard, referred to as "FAS 128," is virtually identical to the Exposure Draft issued in January of last year, and is effective for interim and annual financial statements issued *after* December 15, 1997.(2) The new standard requires all public companies with outstanding stock options and other stock-based awards to *always* compute and disclose two forms of EPS, one that includes the dilutive effect of stock options and other stock-based awards and one that does not. The dual reporting requirements under the new standard, coupled with the new pro forma footnote disclosures prescribed under FAS 123, could significantly enhance the public's ability to assess the potential dilution created by stock-based compensation programs.(3)

Prior EPS Disclosures

Under previous accounting rules (APB Opinion No. 15), companies were required to include the dilutive effect of stock-based awards in their EPS calculations only if such inclusion diluted EPS by 3 percent or more. This calculation was commonly referred to as "primary" EPS if stock-based awards were included in the calculation, and simply as EPS (referred to as "simple" EPS in this letter) if they were not. Companies with more exotic forms of convertible securities were further required to compute and disclose a "fully diluted" EPS, which also included potential dilution from stock-based awards and which also was subject to a 3 percent materiality threshold. As a result of these materiality thresholds, a company's EPS disclosure generally consisted of either (1) simple EPS which reflected no potential dilution from stock-based awards, (2) primary EPS which included such dilution, or (3) fully diluted EPS (in addition to either simple or primary EPS) which also included such dilution.

These multiple and somewhat inconsistent disclosure alternatives under the prior rules often made it difficult or impossible for financial statement readers to accurately assess the dilutive impact of stock-based compensation programs. Our review of 1995 annual reports for 50 of the largest U.S. industrial and service companies, for example, indicated that approximately one-half of the population reported only simple EPS, approximately one-third reported both primary and fully diluted EPS, and the remainder reported only primary EPS. In effect, approximately two-thirds of the companies reported only one form of EPS, thus truly masking the potential dilutive effect of stock-based awards. Even for companies reporting two forms of EPS, it was generally not possible to ascertain the dilutive impact of stock-based compensation programs. The Exhibit at the end of this letter summarizes the form of EPS disclosure for each of the 50 companies.

New EPS Disclosures

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(1) Statement of Financial Accounting Standards No. 128, Earnings per Share
(2) Refer to our letter dated April 24, 1996 for a detailed summary of the Exposure Draft
(3) Refer to our letter dated March 20, 1996 for a detailed explanation of the footnote disclosure requirements of FAS 123

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* As reported in the April 29, 1996 issue of *Fortune* magazine

Several provisions under the new standard are likely to reduce or eliminate many of the inconsistent disclosures that inhibited the public's ability to evaluate potential dilution under prior rules. First, the new standard replaces primary EPS with "basic" EPS, and fully diluted EPS with "diluted" EPS. Basic EPS is identical to simple EPS under prior rules and is calculated by dividing net income available to common stockholders by weighted average common shares outstanding, with *no* potential dilution recognized for outstanding stock options or other stock-based awards. Diluted EPS is essentially the same as fully diluted EPS under prior rules, except for subtle modifications to the so-called "treasury stock method."

Second, the new standard requires all companies with outstanding stock options or other stock-based awards to *always* present *both* forms of EPS on the face of the income statement, even if they are the same amount. As a result, financial statement readers will now be provided with clear and consistent "with and without" dilution information not previously available under old disclosure rules. Importantly, the dual EPS disclosure requirements are also applicable to the pro forma footnote requirements for stock-based compensation under FAS 123.

Third, the new standard eliminates the old 3 percent materiality threshold that enabled many companies to entirely exclude the dilutive effect of stock options and other stock-based awards from their EPS calculations. Thus while basic EPS for these companies will remain unchanged from prior simple EPS disclosures, the additional presentation of diluted EPS will likely be *lower* than previous simple EPS disclosures because of the inclusion of previously excluded stock-based awards.

The chart below contrasts the treatment of outstanding stock options and other stock-based awards under prior rules with such treatment under the new standard:

Form of EPS			**Treatment of Outstanding**
Prior Rules		**New Standard**	**Stock Options and Other Stock-Based Awards**
Simple	=	Basic	Not included under either prior rules or new standard
Primary	=	None	Included under prior rules if EPS diluted by 3 percent or more; not applicable under new standard
Fully Diluted	=	Diluted	Included under prior rules if EPS diluted by 3 percent or more; *always* included under new standard, regardless of materiality

Other Considerations

As with any significant change in accounting standards, companies will need to address the impact of the new standard on their short- and long-term incentive plan designs. Because the new standard is effective for calendar year 1997 financial statements, affected plans include current and future year annual bonus plans as well as "in-cycle" and prospective long-term incentive plans. Companies using EPS as a performance measure should review current plan documents and award agreements to determine whether old or new accounting standards apply, and to address any ambiguities or inconsistencies as appropriate. On a going-forward basis, if diluted EPS replaces old primary EPS as the new performance benchmark for industry analysts, diluted EPS may also evolve as the measure of choice over basic EPS in incentive plan design.

Lastly, for incentive plans affecting current and potential proxy-named officers, companies should ensure their continuing compliance with the "performance-based exception" to the $1 million compensation deduction limitation rules. First, the definition of EPS in shareholder-approved plan documents should be sufficiently broad to encompass the two forms of EPS under the new standard. Second, the definition of EPS in award agreements should be specific enough so as to satisfy the "behind-the-scene" administrative requirements, i.e., the "preestablished objective" and "committee certification" rules.

Summary

The major technical provisions of the new standard that affect executive compensation are summarized below:

Basic EPS – Net income available to common stockholders divided by weighted average common shares outstanding, with no potential dilution recognized for outstanding stock options or other stock-based awards
Diluted EPS – Includes the dilutive effect of stock-based awards and other potentially dilutive securities in the basic EPS calculation; companies with outstanding stock options and other stock-based awards must *always* disclose diluted EPS in addition to basic EPS, regardless of materiality
Treasury Stock Method – Methodology used to compute the dilutive effect of stock options and other stock-based awards for diluted EPS; assumes all stock-based awards are exercised or converted at the beginning of the reporting period (or at issuance, if later), and the proceeds received from such hypothetical exercise or conversion are applied to repurchase outstanding common stock at the *average* market price during the period; "proceeds" include not only the exercise price, but also any "unrecognized compensation cost" and "tax benefits" resulting from the assumed exercise
Contingently Issuable Shares – Stock options and other stock-based awards that are subject to performance criteria other than continued service, such as earnings or stock price goals; such awards are included in diluted EPS (via the treasury stock method) *only* if the relevant performance criteria are currently being satisfied, assuming the end of the reporting period is the end of the contingency period
No Antidilution – Outstanding stock options and other stock-based awards are included in the calculation of diluted EPS only if they are *dilutive*, i.e., the inclusion of such awards either decreases EPS or increases loss per share; the "control number" used to determine such dilution is "income from continuing operations," not "net income"
Required Disclosures – Companies with outstanding stock options and other stock-based awards must present basic *and* diluted EPS on the face of the income statement for income from continuing operations and net income, with a footnote reconciliation of the numerator and denominator of basic EPS to diluted EPS; separate EPS disclosures are required on the income statement or in a footnote if there are other separately stated items, such as discontinued operations, etc.

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General questions may be addressed to Thomas Haines at 312-332-0910. Specific questions should be addressed to the company's appropriate counsel.

Exhibit

1995 Earnings per Share Disclosure
Among 50 Large U.S. Companies

Fortune Rank*	Company	Earnings per Common Share Simple	Primary	Fully Diluted
31	Allstate	X		
54	Atlantic Richfield		X	
25	American International Group	X		
45	American Stores	X		X
23	Amoco	X		
53	AMR		X	X
5	AT&T	X		
37	BankAmerica Corp.		X	X
49	BellSouth	X		
40	Boeing	X		
18	Chevron	X		
9	Chrysler		X	X
42	Cigna	X		
19	Citicorp		X	X
48	Coca-Cola	X		
51	Columbia/HC Healthcare		X	
26	ConAgra		X	
28	Dayton Hudson		X	X
36	Dow Chemical	X		
13	DuPont	X		
3	Exxon	X		
32	Fed. Natl. Mortgage Assn.		X	
52	Fleming	X		
2	Ford Motor		X	X
7	General Electric	X		
1	General Motors	X		
38	GTE	X		
20	Hewlett-Packard		X	
6	IBM	X		
39	International Paper	X		
34	J.C. Penney		X	X
43	Johnson & Johnson	X		
16	Kmart		X	
27	Kroger		X	X
29	Lockheed Martin	X		X
44	Loews	X		
33	Merrill Lynch		X	X
8	Mobil	X		
24	Motorola		X	X
21	PepsiCo		X	
10	Philip Morris	X		
46	PriceCostco		X	X
17	Procter & Gamble		X	X
50	Sara Lee		X	X
15	Sears, Roebuck		X	
14	Texaco	X		
30	United Technologies		X	X
47	USX		X	X
4	Wal-Mart Stores	X		
41	Xerox		X	X
	Number of companies	26	24	18
	Percent of companies	52%	48%	36%