April 24, 1996

FASB Proposes Changes in
Calculation and Presentation of Earnings Per Share

Earlier this year, the Financial Accounting Standards Board (FASB) issued an Exposure Draft that would significantly change the manner in which companies calculate and disclose earnings per share (EPS) in their financial statements.[1] The proposed changes, which would be effective for 1997 calendar year financial statements, would require public companies with outstanding stock options and other stock-based awards to *always* compute and disclose two forms of EPS. The first presentation, referred to as "basic" EPS, would replace "primary" EPS under current rules and would *not* reflect potential dilution from outstanding stock-based awards. The second presentation, referred to as "diluted" EPS, would be essentially the same as "fully diluted" EPS under current rules except for certain adjustments to the dilution calculation for outstanding stock-based awards. The proposed rules are generally non-controversial, and thus are likely to be adopted with only minor changes (if any) by the proposed effective date.

Relevance to Executive Compensation

EPS represents one of the most widely used performance measures in both short-term and long-term incentive programs. Changes in the computation and presentation of EPS, therefore, may need to be addressed in the design and administration of affected programs. At a minimum, award agreements should specify the extent to which changes in accounting provisions affect award payments. Companies with long-term incentive plans covering several fiscal years could specify, for example, that accounting rules at the *start* of the performance period govern award payments and any rule changes during the performance period are disregarded. Outstanding award agreements that lack such specificity may need to be amended.

In addition, companies should review plan documents and award agreements to ensure continuing compliance with the $1 million compensation deduction limitation rules. The definition of EPS should be sufficiently broad in plan documents to continue to satisfy the "shareholder disclosure" rules, and should be specific enough in award agreements and compensation committee minutes to meet the "preestablished objective" and "certification" administrative requirements.

Current Rules

In its simplest terms, EPS is net income available to common stockholders divided by weighted average total common shares outstanding. Under current accounting rules governed by Accounting Principles Board Opinion No. 15 (APB 15) and related pronouncements, the denominator of EPS must also include the dilutive effect of all stock options and other stock-based awards outstanding at year end, if such inclusion reduces EPS by 3 percent or more. This presentation is commonly referred to as "primary" EPS. Further, companies with certain other

[1] Exposure Draft No. 157-B, Earnings per Share and Disclosure of Information about Capital Structure; issued January 19, 1996

potentially dilutive securities (such as some forms of convertible debt) must also compute and disclose a "fully diluted" EPS, subject to a similar 3 percent dilution test. Because of these materiality thresholds, many companies currently compute and disclose only a singular EPS, which *excludes* the dilutive effect of such outstanding stock options and other securities.

Treasury Stock Method

The dilutive effect of outstanding stock options and other stock-based awards is calculated using the so-called "treasury stock method." Under this method, such awards are assumed to be 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 stock at the market price during the period. For purposes of the calculation "proceeds" include not only the exercise price, but also any "unrecognized compensation cost" and "tax benefits" resulting from the assumed exercise.

The treasury stock method is generally the same for both primary and fully diluted EPS, with three notable exceptions. First, the assumed proceeds and repurchase price are based on "average" market price and unrecognized compensation cost for primary EPS, but on the higher of "average" or "end-of-period" for fully diluted EPS. Second, "performance-vesting" awards are generally included in primary EPS based on *actual* performance to date, but in fully diluted EPS assuming *maximum* performance is achieved (with prior period restatement required if previously included awards are subsequently forfeited). Third, the new pro forma footnote disclosure provisions of Financial Accounting Standards No. 123 (FAS 123) are based on only the outstanding stock options *expected to vest* for primary EPS, but on *all* outstanding stock-based awards for fully diluted EPS (all outstanding stock-based awards are included in both primary and fully diluted EPS under the compensation cost recognition provision of Accounting Principles Board Opinion No. 25 (APB 25)).

Outstanding stock options and other stock-based awards are included in the calculation of primary and fully diluted EPS only if they are *dilutive*, i.e., the inclusion of such awards either decreases EPS or increases loss per share. Under the recognition provisions of APB 25, dilution generally occurs only when stock options are "in-the-money." Under the footnote disclosure provisions of FAS 123, however, in-the-money stock options may *not* be dilutive if there is significant unrecognized compensation cost (which is deemed to be "proceeds" under the treasury stock method).

While the logic and rationale of the treasury stock method is conceptually defensible, the practical application of such methodology is often numbingly complex. The Exhibit provides a *simplified* example of the nuances associated with calculating primary and fully diluted EPS under the current and proposed rules for both APB 25 and FAS 123.

Proposed Rules

The proposed rules, which would supersede APB 15 and related interpretations, would be effective for interim and annual reporting periods *ending* after December 15, 1997. Earlier adoption is prohibited, and all reported prior-period EPS data must be restated upon adoption. Under the proposed rules, primary EPS is replaced with "basic" EPS and fully diluted EPS is replaced with "diluted" EPS. All companies are required to present basic EPS for both income from continuing operations and net income on the face of the income statement. Companies with outstanding stock options or other stock-based awards are additionally required to disclose diluted EPS (with a reconciliation of the numerator and denominator to basic EPS), even if it is the same amount as basic EPS. Separate EPS disclosures are required (either in the income statement or in a footnote) if there are extraordinary items, discontinued operations, or cumulative effects of an accounting change.

Basic EPS is defined simply as net income available to common stockholders divided by weighted average common shares outstanding, with *no* potential dilution considered for outstanding stock options or other stock-based awards. Diluted EPS is essentially the same as fully diluted EPS under current rules, except for the following changes to the treasury stock method: (1) using "average" market price and unamortized compensation cost, rather than the higher of "average" or "end-of-period," (2) including performance-vesting awards based on "actual" performance to date, rather than assuming "maximum" performance is attained (with no prior period restatement required), and (3) eliminating the little-used "modified treasury stock method" for companies with outstanding stock options exceeding 20 percent of total shares outstanding.

For purposes of determining whether outstanding dilutive stock options and other stock-based awards are to be included in diluted EPS, the "control number" under the proposed rules is income from continuing operations rather than net income as under the current rules. Thus, stock options and other stock-based awards are *not* included in diluted EPS if there is a loss from continuing operations, even if the company reports net income.

Summary

The major changes under the proposed rules which affect executive compensation are summarized below for both basic and diluted EPS:

Basic EPS:	• Outstanding stock options and other stock-based awards are *excluded* from calculation
Diluted EPS:	• Essentially same as fully diluted EPS under current rules • *Always* presented if there are outstanding stock options or other stock-based awards (even if same amount as basic EPS) • Dilution test based on income from continuing operations • Treasury stock method based on *average* market price and unrecognized compensation cost • Performance awards based on *actual* performance to date, with no prior period restatement • "Modified treasury stock method" *eliminated* from calculation

❖ ❖ ❖ ❖ ❖

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

Comparison of EPS Calculations
Under Current and Proposed Rules
(000)

a	Ending price	$	45.00
b	Average price	$	40.00
c	Exercise price	$	30.00
d	Fair value	$	12.00
e	Tax rate		40.0%
	Vesting 100 percent after 1 year;		
	No estimated forfeitures		

-- Under *current* rules, the potential dilution from outstanding stock options is immaterial (less than 3 percent); thus, only the undiluted EPS on line "j" needs to be presented

-- Under *proposed* rules, the EPS on lines "s" and "cc" need to be reported, regardless of materiality

			Current Rules		Proposed Rules	
	Before Dilution:	**Calculation**	**APB 25**	**FAS 123**	**APB 25**	**FAS 123**
f	Net Income (before compensation cost)	given	$ 250,000	$ 250,000	$ 250,000	$ 250,000
g	Compensation cost (net of tax)	none	$ -		$ -	
		d*u*(100%-e)		$ 36,000		$ 36,000
h	Net Income (avail. to common stock)	f-g	$ 250,000	$ 214,000	$ 250,000	$ 214,000
i	Shares outstanding (weighted avg.)	given	100,000	100,000	100,000	100,000
j	Earnings per share (EPS)	h/i	$ 2.50	$ 2.14	$ 2.50	$ 2.14
	Primary / Basic EPS:					
k	Gross shares under option (5.0% outstdg.)	i*5%	5,000	5,000		
	Assumed exercise proceeds:					
l	-- Exercise price	c*k	$ 150,000	$ 150,000		
m	-- Unrecognized compensation cost	none	$ -			
		d/2*k		$ 30,000		
n	-- Tax benefit credited to capital	(b-c)*k*e	$ 20,000			
		(b-c-d)*k*e		$ -		
o	-- Total proceeds	l+m+n	$ 170,000	$ 180,000		
p	Repurchased shares	o/b	4,250	4,500		
q	Net shares under option	k-p	750	500		
r	Adjusted shares outstanding	i+q	100,750	100,500	100,000	100,000
s	Primary / Basic EPS	h/r	$ 2.48	$ 2.13	$ 2.50	$ 2.14
t	-- Dilution	s-j	$ (0.02)	$ (0.01)	$ -	$ -
	Fully Diluted / Diluted EPS:					
u	Gross shares under option (5.0% outstdg.)	i*5%	5,000	5,000	5,000	5,000
	Assumed exercise proceeds:					
v	-- Exercise price	c*u	$ 150,000	$ 150,000	$ 150,000	$ 150,000
w	-- Unrecognized compensation cost	none	$ -	$ -	$ -	
		d/2*u				$ 30,000
x	-- Tax benefit credited to capital	(a-c)*u*e	$ 30,000			
		(a-c-d)*u*e		$ 6,000		
		(b-c)*u*e			$ 20,000	
		(b-c-d)*u*e				$ -
y	-- Total proceeds	v+w+x	$ 180,000	$ 156,000	$ 170,000	$ 180,000
z	Repurchased shares	y/a	4,000	3,467		
		y/b			4,250	4,500
aa	Net shares under option	u-z	1,000	1,533	750	500
bb	Adjusted shares outstanding	i+aa	101,000	101,533	100,750	100,500
cc	Fully Diluted / Diluted EPS	h/bb	$ 2.48	$ 2.11	$ 2.48	$ 2.13
dd	-- Dilution	cc-j	$ (0.02)	$ (0.03)	$ (0.02)	$ (0.01)

Spreadsheet may be downloaded from the firm's web site at http://fredcook.com.