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Recent Developments Regarding the Effect of Equity Compensation on Earnings per Share

There are two recent developments that we wish to alert our readers about regarding the effect of equity compensation (referred to as "share-based payments") on the calculation of basic and diluted earnings per share (EPS).

> First, a recent FASB Staff Position provides guidance that could adversely affect EPS for share-based payments classified as "equity awards" that pay non-forfeitable dividends or dividend equivalents. Potentially affected awards include dividend-paying stock-settled stock options, stock appreciation rights (SARs), performance shares or share units, and restricted shares or share units.
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> Second, a recent FASB Exposure Draft provides guidance that could favorably affect EPS for share-based payments classified as "liability awards." Potentially affected awards include cash-settled SARs, performance share units, restricted share units, and cash-denominated performance units settled in stock.

FASB Statement 128

As a refresher, the accounting guidance for calculating EPS is found in FASB Statement 128. Statement 128 applies to companies with publicly held stock or potential common shares and requires them to present "basic" and "diluted" EPS on the income statement for income from continuing operations and net income. Basic EPS is defined as net income available to common stockholders divided by weighted average common shares outstanding. Diluted EPS is defined as basic EPS plus the dilutive effect of share-based payments and other potentially dilutive common shares included in the denominator. Share-based payments are included in the denominator of diluted EPS using the "treasury stock method," which assumes all share-based payments are exercised or converted at the beginning of the reporting period (or at issuance, if later) and the "assumed proceeds" received from such hypothetical exercise or conversion are applied to repurchase outstanding common shares at the average market price during the period. For purposes of this calculation, assumed proceeds include not only the exercise price but also any "unrecognized compensation cost" and "tax benefits" resulting from the assumed exercise. Share-based payments that are subject to performance criteria other than continued service (such as earnings or stock price goals) are referred to as "contingently issuable shares." Such awards are included in diluted EPS using 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 performance period.

FASB Staff Position EITF 03-6-1

The first development is the release on June 16, 2008 of an FASB Staff Position titled FSP EITF 03-6-1, which is effective for interim and annual financial statements issued after December 15, 2008 (that is, calendar 2009 financial statements), with retrospective restatement of prior periods required.

The issue involves share-based payments classified as equity awards that pay currently or accrue *non-forfeitable* dividends or dividend equivalents during the earnout, vesting, or exercise period. Potentially affected equity awards include any grant type that pays or accrues dividends or dividend equivalents regardless of whether the underlying equity awards are earned. Importantly, the issue does not apply to equity awards that provide for *forfeitable* dividends or dividend equivalents, including payments in the form of a reduction in exercise price. Thus, equity awards that accrue or credit and reinvest dividends or dividend equivalents during the earnout, vesting, or exercise period and distribute only in proportion to the number of underlying shares or share units that are ultimately earned (if any) are unaffected by the issue. In addition, the issue is not relevant with respect to share-based payments classified as liability awards, because as discussed below, such awards would no longer be included in the denominator of basic or diluted EPS.

The non-forfeitable dividend feature makes equity awards become what accountants refer to as "participating securities." These participating securities are required to be included in the denominator of both basic and diluted EPS using the "the two-class method," as opposed to only included in the denominator of diluted EPS using the treasury stock method. The two-class method is complex and not intuitive, but our understanding is that essentially the full number of outstanding nonvested or unexercised equity awards is included in the denominator, with an adjustment for dividends recognized as compensation cost for equity awards not expected to vest (if any). While this dividend adjustment somewhat reduces the number of shares included in the denominator, our understanding is that even after this adjustment, more shares would be included in the denominator than under the treasury stock method.

In our experience with respect to performance shares or share units, it more common for companies to pay or accrue forfeitable rather than non-forfeitable dividends or dividend equivalents. Thus, many companies with these awards should be unaffected by the new guidance. For awards that do pay or accrue non-forfeitable dividends or dividend equivalents, however, the consequences could be material because the full number of outstanding nonvested or unexercised equity awards would be included in the denominator of both basic and diluted EPS (net of the adjustment for dividends, as discussed above). Under previous practice, no shares were included in the denominator of basic EPS, and because performance shares or share units are considered contingently issuable shares, no shares were usually included in the denominator of diluted EPS under the treasury stock method until the end of the performance period.

In contrast, in our experience with respect to restricted shares or share units, it is more common for companies to pay or accrue non-forfeitable rather than forfeitable dividends or dividend equivalents. Thus, many companies with these awards could be adversely affected by the new guidance. Similar to performance shares or share units, the impact on basic EPS could be significant. However, the impact on diluted EPS should not be as significant as with performance shares or share units because restricted shares or share units are already included in the denominator of EPS under the treasury stock method from the date of grant.

Statement 128 Exposure Draft

The second development is the re-release on August 7, 2008 of an FASB Exposure Draft amending Statement 128. The comment deadline for the Exposure Draft is December 5, 2008, and there is no proposed effective date yet. There are four important proposed changes with respect to accounting for share-based payments.

First, share-based payments classified as liability awards would no longer be included in the denominator of basic or diluted EPS under either the treasury stock method or the two-class method. The stated rationale is that the liability award's fair value is already recognized as compensation cost in the numerator, and to also include the potential common shares in the denominator would be double counting. Ironically, during the deliberations of FASB Statement 123R, the business community used the reverse argument in an attempt to persuade FASB not to expense options, stating it would result in double counting because the dilutive effect of options was already reflected in the denominator of diluted EPS.

Second, the treasury stock method would be amended to include as assumed proceeds the end-of-period "carrying value" of certain liabilities that are settled in stock. We believe such liabilities would include cash-denominated performance units settled in stock. The impact of this change is that such awards would have no dilutive effect on diluted EPS.

Third, the treasury stock method would be amended to assume end-of-period exercise or conversion (rather than beginning-of-period) and end-of-period stock price (rather than average stock price during the period) to calculate the incremental shares issued upon assumed exercise.

Fourth, for share-based payments that permit or require either cash or share settlement, companies would be *required* to assume share settlement in the diluted EPS calculation, with a limited exception for share settlements conditioned solely on bankruptcy. Previously, companies where permitted to assume cash settlement (and thus no dilution) if a past pattern of cash settlement existed.

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General questions about this summary can be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by email at tmhaines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this letter and other published materials are available on our website at www.fwcook.com.