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New York • Chicago • Los Angeles

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STANDARD & POOR'S INTRODUCES "CORE EARNINGS" DEFINITION THAT INCLUDES STOCK OPTIONS AS AN EXPENSE

Standard & Poor's ("S&P") recently introduced a new definition of operating earnings, referred to as "Core Earnings", in an effort to improve the consistency with which companies disclose earnings from primary businesses. A significant difference between Core Earnings and other measures of earnings that companies report to investors is that Core Earnings will treat stock option grants as an expense.

This development is of interest to compensation professionals since company Core Earnings that reflect the "cost" of stock options will be included in S&P's financial information reports and databases, which are widely used by investors and analysts.

Forces Behind Core Earnings Definition

The introduction of Core Earnings as a new performance measure is the culmination of a six month project initiated by S&P. The objectives of this project were to improve the consistency of reported financial results across companies and make earnings reports easier for analysts and investors to understand. To assist in achieving these objectives, the Core Earnings definition includes stock options as an expense.

In recent months, several forces, most notably Alan Greenspan and the International Accounting Standards Board, have reignited the debate as to how stock options should be accounted for. The majority of companies account for stock options in their financial statements using Accounting Principles Board Opinion No. 25 (APB 25), which generally does not require a charge to earnings for options granted at-the-money, and disclose *pro-forma* earnings that include the "cost" of stock options in the footnotes to the financial statements, as required under Statement of Financial Accounting Standards No. 123 (SFAS 123). The forces for change would like the "cost" of stock options to be reflected on the income statement, presumably in addition to separate disclosure in the footnotes. By deducting the "cost" of stock options to derive Core Earnings, S&P makes a significant move towards changing the financial reporting of stock options.

Core Earnings Definition

Core Earnings is defined as the after-tax earnings generated from a corporation's principal business or businesses. The measure seeks to reveal a company's underlying earnings potential by including/excluding revenues and costs that are/are not related to a company's primary businesses, thus allowing investors to focus on the company's results from ongoing operations.

The calculation of Core Earnings begins with a company's reported net income before discontinued operations, extraordinary items and cumulative effect of accounting changes, as calculated in accordance with Generally Accepted Accounting Principles (GAAP). Reported net income is then adjusted by the following items to derive Core Earnings:

Items Included and Excluded in Core Earnings	
Included in Core Earnings	**Excluded from Core Earnings**
• Employee stock option grant expense	• Goodwill impairment charges
• Restructuring charges from ongoing operations	• Gains/losses from asset sales
• Write-downs of depreciable or amortizable operating assets	• Pension gains
• Pension costs	• Unrealized gains/losses from hedging activities
• Purchased research & development expenses	• Merger/acquisition related expenses
	• Litigation or insurance settlements and proceeds

Inclusion of Stock Options in Core Earnings

S&P's rationale for including the "cost" of stock options in the Core Earnings definition is that stock options are part of employee compensation packages and therefore should be treated for accounting purposes in the same manner as all other compensation elements, which are charged to earnings as expense.

The expense of stock options will be determined in accordance with SFAS 123, with the expense equal to the "fair value" of the stock options at grant date as determined by an option pricing model, such as the Black-Scholes or binomial model. The expense associated with stock options that is disclosed in the footnotes to financial statements will be used to calculate Core Earnings.

Under SFAS 123, companies are required to disclose stock option expense, along with the inputs to the option pricing model that were used to derive "fair value" in the annual financial statements. However, to facilitate the calculation of quarterly Core Earnings, S&P has requested that companies provide the following information, in tabular form, in their quarterly earnings release: number of options granted, option term, strike price, stock price on grant date, stock dividend rate, risk-free rate and volatility. While not specifically requested, presumably companies would also need to disclose the expected option term, vesting provisions and expected forfeiture rates so that the "fair value" of the options could be calculated in accordance with SFAS 123.

Since S&P has no authority to require that companies provide the above data quarterly, and until such time that reporting requirements change or sufficient companies voluntarily disclose the requested information, S&P will publish quarterly Core Earnings *excluding* stock option expense and annual Core Earnings *including* stock option expense.

<u>Use of Core Earnings</u>

S&P will utilize the Core Earnings measure in the following ways:

- Core Earnings per share will be published for all companies included in S&P's U.S. equity indices, including the S&P 500
    - With stock option expense included in annual earnings only, so far
- S&P Compustat, a financial research service that covers more than 10,000 U.S. corporations, will include relevant data to facilitate the calculation and analysis of Core Earnings
- S&P's equity analytical group will use Core Earnings in its analyses
- Core Earnings will also be considered by S&P as part of its debt rating activities

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This letter is intended to alert compensation about developments that may affect their companies. General questions about Standard & Poor's Core Earnings definition may be addressed to Erin Bass-Goldberg at (636) 519-0560. This letter and other published materials are available on our website, www.fwcook.com.