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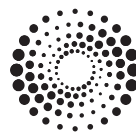

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How equity-based compensation affects EPS

No single number can fully reflect a company's financial performance. But public company investors, as well as financial analysts and the business media, generally believe that earnings per share (EPS) comes close. Given the significance of EPS, it's important to understand how equity-based compensation programs affect its calculation.

Two types

Companies with publicly held common stock — or potential common stock, including equity-based compensation — are required to present EPS on their income statements according to the Financial Accounting Standards Board's (FASB's) Accounting Standards Codification (ASC) 260. Generally, this takes two forms:

1. Basic. This is the income available to common shareholders (that is, net income or loss adjusted for preferred dividends) divided by the weighted average number of common shares outstanding. A weighted average is used because the number of outstanding shares can fluctuate during a reporting period. Thus, the number of shares is time-weighted based on the fraction of the reporting period during which shares are outstanding. (See "EPS in motion" on page 3 for an example.)

2. Diluted. Companies with "complex capital structures" — those with potential common stock — must also report diluted EPS. Potential common stock may take the form of options, warrants, convertible securities or other dilutive financial instruments that, upon exercise or conversion, would increase the number of common shares and, therefore, reduce EPS.

Diluted EPS assumes that potential common shares are issued and adds that number to the denominator of the EPS formula (unless, as discussed below, the shares would have an *antidilutive* effect). To accurately measure the impact on EPS, it's also necessary to make some adjustments to the numerator. For example, if diluted EPS assumes the conversion of preferred stock or debt securities into additional shares of common stock, earnings used in the numerator should be adjusted to reflect avoided preferred dividend and interest payments and other changes that would result.

Both calculations are significant. Basic EPS reflects the current earning power of a company's common stock, while diluted EPS measures how the exercise or conversion of dilutive securities would affect EPS in the event all were exercised or converted.

Impact of options

The potential impact of equity-based compensation on EPS depends on the compensation type. Stock options, for example, aren't included in the calculation of basic EPS. But for purposes of diluted EPS, it's assumed that options are exercised at the beginning of the reporting period (or, if later, when issued).

For options, ASC 260 requires companies to use the "treasury stock method" to compute diluted

EPS. That method assumes that the company uses the proceeds from a hypothetical option exercise to repurchase outstanding common shares at the average market price during the reporting period. Assumed proceeds include the exercise price as well as certain tax benefits and unrecognized compensation costs associated with exercise of an option.

However, when there's a loss for the reporting period, potential common shares aren't included in the diluted earnings per share calculation because to do so would be antidilutive. This might be the case if, for example, the exercise price exceeds the stock's market value. Under those circumstances, the assumed number of shares bought back by the company would exceed the assumed number of shares issued to the option holder, resulting in a net loss of common shares.

EPS in motion

To understand how equity-based compensation can affect EPS, consider the following example:

On Jan. 1, 2010, a public company had 150,000 shares of common stock outstanding. It also had 20,000 preferred shares with a par value of $100 per share and a 6% dividend preference. On Sept. 1, the company issued an additional 30,000 shares of common stock. Its net income for the year was $2 million.

For basic EPS, preferred dividends must be calculated: 20,000 shares × $100 × 6% = $120,000.

The weighted average of the company's outstanding common shares is:

Time period	Outstanding shares	Fraction of year	Weighted shares
Jan. 1 to Aug. 31	150,000	2/3	100,000
Sept. 1 to Dec. 31	180,000	1/3	60,000
			160,000

$$\text{Basic EPS} = \frac{\text{Net income - preferred dividends}}{\text{Weighted average number of outstanding shares}} = \frac{\$2 \text{ million} - \$120{,}000}{160{,}000} = \$11.75$$

Now let's say the company has issued options to buy 60,000 shares of common stock for $100 per share and that the stock's market price is $120. To calculate diluted EPS (disregarding the potential tax impact in this example), it's assumed that all of the options are exercised, yielding proceeds of $6 million (60,000 × $100). Under the treasury method, it's further assumed that the company uses the proceeds to buy stock at market value. At $120 per share, the company can buy 50,000 shares ($6 million/120) . Thus, the "dilutive effect" of the options is 10,000 shares (60,000 - 50,000).

$$\text{Diluted EPS} = \frac{\$2 \text{ million} - \$120{,}000}{160{,}000 + 10{,}000} = \$11.06$$

Effect of restricted stock

Awards of restricted stock and restricted stock units (RSUs) are treated like options for EPS purposes. In most cases, unvested awards are excluded from basic EPS and are included in diluted EPS. Once vested, these awards are included in basic EPS — even if, in the case of RSUs, the shares haven't actually been issued.

For purposes of computing diluted EPS, restricted stock and RSUs are considered outstanding at the beginning of a reporting period, even though they're contingent on an employee's continued service. But performance-based awards that are contingent on earnings or stock price targets aren't included in diluted EPS unless those targets are being met as of the end of the reporting period. Under certain circumstances, unvested restricted stock or RSUs are included in the computation of basic EPS. This is the case when unvested awards pay *nonforfeitable* dividends and, therefore, are considered "participating securities"

under ASC 260's "two-class method" for calculating basic EPS.

That method applies an "earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings." This approach recognizes the impact of nonforfeitable dividends on basic EPS regardless of whether equity awards ultimately vest.

Consider all factors

When evaluating which type of incentive compensation to award, be sure to consider the potential impact on your company's financial statements. The specific terms and conditions of equity-based compensation such as stock options, restricted stock and RSUs can make a big difference in the way they're treated for purposes of EPS. Of course, it's important to consider other financial and tax implications as well.

Does say-on-pay create a Catch-22 for companies?

The "say-on-pay" provision in last year's Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires companies to give shareholders a nonbinding "advisory" vote on compensation for top executives. But companies hoping to adjust executive compensation to ease shareholder concerns face a dilemma: Attempts to modify nonqualified deferred compensation arrangements may run afoul of Internal Revenue Code Section 409A.

Temporary exemption

Say-on-pay rules apply to a company's "named executive officers": the CEO (or principal executive officer), CFO (or principal financial officer) and the next three most highly compensated executives. Dodd-Frank requires public companies to hold say-on-pay votes beginning with the first annual meeting after Jan. 21, 2011.

However, the SEC's final rules have deferred this requirement for two years for smaller reporting companies — generally, those with a public float of less than $75 million. This temporary exemption applies only to say-on-pay votes, not, for example, "say-on-golden-parachutes" requirements.

Once a company holds its first say-on-pay vote, similar votes must occur at least once every three years. But Dodd-Frank also requires companies to give shareholders an advisory vote — at least once every six years starting with the first annual meeting after Jan. 21, 2011 — on the frequency of say-on-pay votes. These "say-on-frequency"

votes allow shareholders to choose whether to conduct say-on-pay votes annually or every two or three years, or to abstain from voting.

Sec. 409A in play

Congress added Sec. 409A to the Internal Revenue Code in 2004. This addition was largely in response to reports of abuses by public companies that accelerated payments of nonqualified deferred compensation benefits to executives on the eve of bankruptcy.

Sec. 409A covers most nonqualified deferred compensation plans, including supplemental executive retirement plans, most bonus plans, certain severance pay arrangements and discounted stock options and stock appreciation rights. It doesn't apply to qualified retirement plans, such as 401(k) plans, or to most welfare benefit plans, such as vacation and sick leave, compensatory time, or disability coverage.

The rule is designed to strictly limit the flexibility of companies and executives to control or change the timing of deferred compensation payments. It mandates that:

- The initial election to defer compensation be made *before* the year in which the compensation will be earned,
- The arrangement call for payments be made according to a fixed schedule or upon the occurrence of an event, such as death, disability or termination of employment, and
- Once the arrangement is in place, the executive generally be prohibited from accelerating benefits.

Executives may further *defer* benefits, but only if they 1) elect to do so at least 12 months before a payment is due, and 2) defer the payment by at least five years.

Don't take shortcuts

Failure to comply with Sec. 409A's requirements results in immediate taxation of all vested deferred compensation, plus a 20% penalty and interest. This can be particularly harsh because executives are hit with a substantial tax bill on compensation that they won't receive until a future date.

If you think you can get around Sec. 409A's restrictions simply by terminating a deferred compensation arrangement (or reducing its benefits) and establishing a new one, think again. If this strategy is deemed to be a "substitution," it will be treated as an impermissible acceleration of the terminated benefits. The executive will owe tax on the compensation as of the date it was originally deferred, plus interest and penalties.

Stock and a hard place

Sec. 409A is a significant obstacle for companies that want to modify executive compensation. Suppose, for example, that shareholders vote to disapprove a CEO's vested deferred compensation benefits as excessive. To appease shareholders, the CEO might want to forfeit a portion of these benefits in exchange for future equity awards contingent on the company achieving meaningful performance goals.

If you think you can get around Sec. 409A's restrictions simply by terminating a deferred compensation arrangement and establishing a new one, think again.

Unfortunately, this approach would likely violate Sec. 409A, triggering the negative tax consequences described above. Unless the IRS or Congress changes the rules, companies will have limited options for restructuring executive compensation.

Impact assessment critical

Under current law, making changes to an executive's nonqualified deferred compensation — even for legitimate business reasons — presents tax risks. If your company is considering such changes, assess the potential impact of Sec. 409A now.

Final whistleblower rules

SEC addresses internal reporting concerns

One of the more controversial provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was to provide significant cash incentives to whistleblowers who report suspected financial misconduct directly to the SEC, instead of reporting it internally. The SEC's recently finalized whistleblower rules have addressed some critics' concerns.

Powerful incentives

The Dodd-Frank Act authorizes the SEC to reward individuals who voluntarily provide the agency with "original information" about securities law violations that lead to successful enforcement actions resulting in monetary sanctions in excess of $1 million. Reward amounts range from 10% to 30% of monetary penalties recovered by the SEC.

> *Public companies should ensure that their internal compliance and reporting systems encourage employees to report suspected misconduct internally.*

Although such rewards provide a powerful incentive to report misconduct, some critics have worried that it encourages employees to bypass their employer's internal compliance and reporting systems, thereby delaying investigation and resolution of the matter. They've suggested that the SEC *require* whistleblowers to report suspected misconduct internally *before* going to the SEC, as a condition of collecting a reward.

Opponents of this approach have argued that requiring an internal report would discourage whistleblowers from coming forward.

SEC modifies rules

In its recently finalized whistleblower rules, the SEC declined to require internal reporting, but it did provide several financial incentives for doing so. Notably, the final rules permit the SEC to grant higher rewards to whistleblowers who voluntarily participate in a company's internal reporting process — and reduce rewards for those who don't report internally first.

The final rules also provide that a whistleblower who reports misconduct internally remains eligible for a reward, even if the company comes forward and provides the information to the SEC itself. And they allow whistleblowers who report misconduct internally to preserve their "place in line" for a reward. As long as they provide the same information to the SEC within 120 days, they'll be treated as whistleblowers as of the date they made the internal report.

Rewards, however, aren't available to certain individuals, including:

- In-house counsel or other attorneys,
- Officers and directors who learn of potential misconduct through the company's internal compliance procedures,

- Compliance and internal audit staff, and
- Public accountants.

There's an exception for compliance and internal audit staff and public accountants if 1) they believe that disclosure would prevent substantial injury to the company or its investors, 2) they believe that the company is acting to impede an investigation, or 3) 120 days or more have passed since they reported the information internally.

Do your part

In light of these updates, public companies should take steps to ensure that their internal compliance and reporting systems encourage employees to report suspected misconduct

internally. At the same time, assure them that their information will be taken seriously and won't result in retaliation.

CAQ takes the mystery out of audits

Independent audits of public companies are a critical tool for building confidence in the U.S. capital markets. Yet many investors and other nonauditors lack a full understanding of the audit process and the auditor's responsibilities.

Earlier this year, in an effort to close this knowledge gap, the Center for Audit Quality (CAQ) published its *In-Depth Guide to Public Company Auditing: The Financial Statement Audit*. The guide provides an overview of the audit process, key players and critical issues involved in audits of public companies. It also provides some insight into what an audit report represents and, equally important, what it doesn't.

For example, the guide:

- Provides a basic definition of the public company financial statement audit, making it clear that the goal is to give financial statement users "reasonable — but not absolute — assurance that the financial statements prepared by management are fairly presented,"
- Describes the roles of the key players in an audit, including company management, the audit committee and the independent auditor,
- Explains the importance of the audit firm's quality control system,
- Reviews the steps audit firms take in deciding whether to accept engagements, including background checks and other due diligence procedures to assess management integrity, protect the firm's reputation and ensure auditor independence,
- Details how the audit firm plans the audit, including an assessment of audit risk,
- Outlines the audit process, which entails developing an audit strategy, selecting and performing audit procedures, testing controls, and evaluating the results, and
- Discusses the elements of the audit report and the types of opinions it may express.

Throughout the guide, the CAQ offers insights into key auditing concepts such as internal controls over financial reporting, the auditor's responsibility for detecting fraud, and the auditor's exercise of professional judgment and professional skepticism. You can download the guide at http://thecaq.org.

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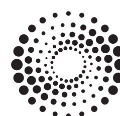

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