Executive Compensation

When Using EPS in Incentive Plans, Take Time to Specify How It's Calculated

By Tom Ramagnano and Michael Meyer

Given its strong alignment with shareholder value creation, earnings per share (EPS) is a common performance metric selected for short-term incentive and long-term incentive plans. A company's generally accepted accounting principles (GAAP)-based EPS is equal to its after-tax net income divided by the number of common shares outstanding (either on a basic or fully diluted basis). However, in performance arrangements, companies often use an adjusted EPS performance measure, which is a non-GAAP measure. Directors should consider examining the different approaches companies use to develop non-GAAP EPS measures when deciding what's best for their own company's compensation program.

Earnings

Companies use EPS performance measures that compute earnings either on a GAAP basis or an adjusted basis. On an adjusted basis, companies use various definitions of earnings from which to derive EPS.

GAAP principles provide a set of policies and rules to help standardize financial reporting among US public companies. However, the financial statements disclose various levels of earnings within the income statement. Examples include gross margin, operating income, income from continuing operations, and net income.

Depending on the circumstances, the reported earnings at each level of the income statement can distort the actual operating results of a business since non-recurring and unusual items may be included (e.g., gain from sale or machinery, write-down of intangible assets, etc.).

Conversely, adjusted (or non-GAAP) earnings are computed by a company to more closely convey the earnings that are derived from the company's core business operations. Therefore, companies typically exclude non-recurring and unusual items to determine an adjusted earnings measure. If a company uses non-GAAP earnings as a performance measure, the company's proxy must show a qualitative reconciliation between the non-GAAP earnings measure and the nearest GAAP measure.

> The most common approach is to use fully diluted shares outstanding to compute EPS for compensation plan purposes.

The first step for companies using an earnings metric in their incentive plans (e.g., the numerator in the EPS equation) is to determine the initial level of GAAP earnings to be used from the income statement. Second, if an adjusted earnings measure is to be used, determine the categories of adjustment that will be applied to the selected GAAP earnings measure to set target performance goals and assess level of performance.

Shares Outstanding

Similar to earnings measurement, there are two common ways to measure shares outstanding for purposes of EPS calculations: basic or fully diluted. Basic shares outstanding refers to the number of shares actually issued and outstanding that are held by investors. Fully diluted shares outstanding includes shares that would become outstanding if all exercisable warrants, stock options, and convertible bonds were converted into shares in addition to the shares actually outstanding. The impact of periodic share repurchases is also an important consideration with EPS goal setting.

Based on our experience, the most common approach is to use fully diluted shares outstanding to compute EPS for compensation plan purposes.

Suggestions for the Board

Companies commonly consider market prevalence, strategic goals, and shareholder expectations when selecting executive incentive plan metrics. However, computation of the metric itself (specifically EPS) is often an afterthought.

Before approving incentive plan design changes, boards should discuss how the selected financial goals will be calculated, the merits of each approach, and how the measure impacts the incentive package.

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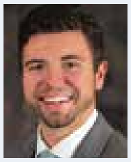

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