Management Accounting Quarterly
VOL.4 NO.1
Fall 2002

"Tracking" Common Stocks and the Potential for Misuse of the Two-Class Method of Calculating Earnings Per Share

BY ROBERT L. MADDOX III, ESQ.

USE SFAS NO. 128 AND IAS 33 FOR THE CORRECT RULES GOVERNING EARNINGS PER SHARE CALCULATIONS.

EXECUTIVE SUMMARY

◆ A tracking stock is a special series of common stock that is designed to reflect (i.e., "track") the performance of one or more specific business units of a company as if each unit were its own separate, standalone company.

◆ When calculating earnings per share (EPS), issuers of tracking stock have tended to reject the standard calculation method (i.e., dividing total corporate net income by all of the outstanding shares of common stock) in favor of the more complex two-class method. Under this method, issuers calculate EPS for the tracking stock and the nontracking stock as though they were issued by two separate companies. That is, the earnings attributable to the tracking stock are divided only by the number of shares of tracking stock outstanding rather than by all of the common stock outstanding (and vice versa for the nontracking stock).

◆ What many issuers fail to recognize is that use of the two-class method is appropriate only when the tracking stock and the nontracking stock have different dividend participation rights *as a matter of law*, which entails a detailed analysis of the issuer's articles of incorporation and other applicable legal governance documents and applicable state corporate law. The stakes are high because improper use of the two-class method can result in significant understatement of the earnings per share of the tracking stock with a corresponding overstatement of the EPS of the nontracking stock. Such misstatements can lead to significant market pricing inaccuracies and trading disparities.

INTRODUCTION

Issuers of tracking common stock have been relying on the two-class method found in the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings Per Share," to calculate their earnings per share.[1] The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock then entitled to participate in dividends. Under this method, earnings are allocated to common stock (and any other securities with dividend participation rights) to the extent that each such security may share in earnings as if all of the earnings for the period had been distributed through dividend payments. The total earnings allocated to each security are determined by adding together the amount allocated for dividends paid and the amount allocated for a dividend participation feature. In order to determine the earnings per share under the two-class method, the total earnings allocated to each class of security are divided by the number of outstanding shares of such security.

Analysis

SFAS No. 128 and its guiding corollary, International Accounting Standard (IAS) 33, "Earnings Per Share,"[2] allow use of the two-class method for calculating EPS when two or more classes of common or other stock exist that have different stated dividend rates and/or different dividend participation rights. While SFAS No. 128 is substantially identical to IAS 33 on the issue of the two-class method, IAS 33 contains a somewhat more detailed discussion of the application of the two-class method and its implementation. Nonetheless, both SFAS No. 128 and IAS 33 make it clear that the key factor justifying use of the two-class method in a given situation is the presence (or absence) of differing dividend rights.

Thus, the basic threshold question for application of the two-class method is: *Do the classes differ in their ability to participate in dividends?* Such a difference can arise out of either (1) different stated dividend rates (e.g., 3% vs. 4%) or (2) the ability to participate in future dividends to unequal degrees. If management can arbitrarily decide how to allocate dividends between tracking stock and nontracking stock (e.g., allocating 100% of available dividends to one and 0% to the other), then two classes of stock do not exist under SFAS No. 128. As a result, the company should calculate EPS by dividing its entire net income by all outstanding shares, both tracking and nontracking.

The amount of dividends payable to holders of tracking stock typically is limited to what is referred to as the "available dividend amount." The available dividend amount is the amount of dividends that could be paid to such holders if the business unit being tracked were, in fact, a separate, free-standing company. As a result, the actual amount of dividends available to be paid to holders of tracking stock under such circumstances has to be determined by calculating the maximum dividend distribution permitted under the applicable state's corporate law.[3] This amount usually is equal to the capital and surplus available within the tracked business unit for payment of dividends.

In order to calculate the tracking stock's right to participate in the issuer's undistributed earnings via dividends (which, in turn, drives management's ability to allocate earnings among classes), the issuer must divide the available dividend amount (i.e., the capital and surplus attributable to the business unit being tracked) by the issuer's total net income reported for the period. If the resulting quotient is one or greater, then the tracking stock is able to participate in up to 100% of undistributed earnings, and the application of the two-class method appears inappropriate. Thus, by not establishing ironclad dividend participation rights among the classes of common stock, tracking stock issuers may not have created two classes of common stock for purposes of SFAS No. 128. Put simply, under such circumstances the denominator in the earnings per share calculation should include all of the common stock outstanding and not just a portion of it.

Apollo Group, Inc.

Let's look at Apollo Group, Inc., as an example. As of May 31, 2002, Apollo Group, Inc., a publicly traded holding company (Apollo), had the following capital structure:

1. 172,843,000 outstanding shares of publicly traded Apollo Group, Inc., Class A nonvoting common stock (the "Class A common"), which are listed on the NASDAQ National Market System under the ticker symbol APOL;

2. 484,000 outstanding shares of privately held Apollo Group, Inc., Class B voting common stock (the "Class B common"), control over which is privately maintained by the Sperling family, Apollo Group, Inc.'s primary shareholders; and

3. 13,550,000 outstanding shares of publicly traded Apollo Group, Inc. nonvoting common stock, which are labeled as shares of the University of Phoenix Online, a division of Apollo Group, Inc. (the "tracking common"), and which are listed separately on the NASDAQ National Market System under the ticker symbol UOPX.[4]

In its filings with the Securities & Exchange Commission (SEC), Apollo's management has stated that the tracking common has been designed to mirror the performance of a specific *unincorporated* business division within Apollo, namely, the University of Phoenix Online. Although the tracking common is a series of the same class of Apollo Group, Inc., common stock as Class A and Class B common, its shares are referred to in the marketplace solely as shares of University of Phoenix Online rather than as shares of Apollo Group, Inc., common stock. The tracking common is listed separately from the Class A common on an exchange with its own separate quotation symbol. The tracking common is convertible into Class A common stock at any time at the discretion of Apollo Group, Inc.'s management, with the conversion ratio being based on the market value per share of the tracking common in relation to Class A common stock at the time of conversion.

Apollo's management has also stated that, as of May 31, 2002, the Class A and B common together are deemed to hold an 87.5% "retained interest" in the business being "tracked."[5] The retained interest is the equivalent of 94,850,000 shares of tracking common. These shares have never been issued, so the per-share earnings of the tracking common have never been diluted accordingly. Apollo Group, Inc., calculates its EPS using the two-class method set forth in paragraphs 60 and 61 of SFAS No. 128. In order to have earnings calculated separately on each class of common stock, Apollo Group, Inc., deems Class A and Class B common to be one class of common stock and the tracking common to be a different class of common stock.

Article 2.1.1. of Apollo Group, Inc.'s *Amended and Restated Articles of Incorporation* (the *Restated Articles*),[6] titled "Limitation on Dividends," places the following restriction on dividends to holders of Apollo Group, Inc., common stock (including the tracking common):

"Dividends on any series of [Apollo Group, Inc.] common stock may be declared and paid only out of the lesser of (a) the funds of the [Apollo Group, Inc.] legally available therefore and (b) the 'available dividend amount' for the class of common stock involved."

The tracking common's "available dividend amount" is defined in Article 2.7.5 of the *Restated Articles* as:

"…the amount that would, immediately prior to the payment of such dividends, be legally available for the payment of dividends on shares of such series of common stock under applicable Arizona [corporate] law if on such day [the University of Phoenix Online] were a single, separate Arizona corporation having outstanding (i) a number of shares of common stock equal to the number of shares of such series of common stock that are then outstanding plus the number of shares issuable with respect to the retained interest of the Class A & Class B common stock owners in the University of Phoenix Online."

Finally, Article 2.1.2 of the *Restated Articles*, titled "Discrimination in Dividends Between Classes of Common Stock," states:

"[Apollo Group, Inc.'s] Board of Directors may at any time declare and pay dividends exclusively on a single series of Common Stock, or on one or more series of Common Stock, in equal or unequal amounts, notwithstanding the relative amounts of the Available Dividend Amount with respect to [the University of Phoenix Online], the amount of dividends previously declared on any series, the respective voting or liquidation rights of any series, or any other factor."

Under applicable Arizona corporate law, if the University of Phoenix Online were a separate, stand-alone entity, it could pay a dividend up to any amount it chose so long as, after payment of such dividend, (1) it was able to pay its debts as they became due in the usual course of business, and (2) its total assets were not less than the sum of its total liabilities. Apollo Group, Inc., typically prepares for inclusion in its quarterly and annual filings a separate balance sheet for the University of Phoenix

Online that reflects the assets and liabilities of the University of Phoenix Online as if it were a stand-alone company.

For its quarter ended May 31, 2002, Apollo Group, Inc., reported net income of $50,799,000, of which $19,668,000 was earned by its University of Phoenix Online business unit[7] and $31,131,000 was earned by its other (i.e., non-University of Phoenix Online) business units. Using the two-class EPS calculation method and allocating 87.5% of the University of Phoenix Online net income to holders of Class A and B common via their retained interest, Apollo Group, Inc., reported basic earnings of $0.28 per share for Class A and B common and $0.18 per share for tracking common.

As disclosed in separately prepared University of Phoenix Online financial statements, as of May 20, 2002, the University of Phoenix Online had total assets of $220,195,000 and total liabilities of $69,034,000. Of such total assets and liabilities, $190,554,000 was listed as current assets and $66,229,000 as current liabilities. Thus, at a minimum, the entire sum of the University of Phoenix Online's current assets minus *total* liabilities (i.e., its *liquid net worth*) of $121,520,000 would be available for payment of dividends.[8]

Because the available amount of dividends potentially payable to holders of tracking common is $121,520,000 (which is well in excess of Apollo Group, Inc.'s reported total net income of $50,799,000 as of May 20, 2002, the assertion that Class A and B common and the tracking common have different dividend rates or are entitled to participate in undistributed earnings via dividend payments to different degrees is inappropriate under SFAS No. 128. That is, because both Class A and B common and tracking common can participate in undistributed earnings at a rate of up to 100% (depending upon how management chooses to act), under SFAS No. 128's guidance, it is disingenuous to claim that two distinct classes of stock exist.

By using the two-class method, Apollo Group, Inc., is misstating the EPS of both the Class A and B and the tracking common. Specifically, the EPS should be calculated by dividing Apollo Group, Inc.'s entire net income by the number of all of its outstanding shares of common stock (i.e., Class A common, Class B common, and tracking common). Such a calculation would result in earnings of approximately $0.27 per share for each share of Class A, Class B, and tracking common (i.e., $50,799,000 divided by 186,877,000 outstanding shares of Apollo common stock). Thus, by using the two-class method, the issuer has arguably overreported its quarterly EPS on its Class A and B common by $0.01 per share (i.e., $0.04 per share annually). More important, Apollo Group, Inc., has, at the same time, underreported quarterly EPS on its tracking common by $0.09 per share (i.e., $0.36 per share annually). The net market price effect of such earnings misstatements can be dramatic. With a current price/earnings (P/E) ratio of 61.4 as of July 31, 2002, a $0.36 per share annual understatement of EPS on the tracking stock could cause the marketplace to undervalue the tracking common by as much as $22.10 per share annually.

To complicate matters, if the two-class method for calculating EPS is not available to Apollo Group, Inc., then its allocation of 87.5% of the tracking common's earnings to Class A and Class B shareholders is proper only if all of the unissued tracking common shares representing such 87.5% retained interest (i.e., 94,850,000 shares) are actually issued to Class A and B common shareholders. Because tracking common is nothing more than Apollo Group, Inc., common stock, the issuance of such 94,850,000 shares would result in an increase in the total outstanding shares of Apollo Group, Inc., common stock to 281,727,000 shares. EPS would then become approximately $0.18 per share for each of the Class A, Class B, and tracking common.

Thus, by siphoning earnings from the tracking common and allocating them to the Class A and B common via the two-class method, Apollo Group, Inc., is able to make the performance of its Class A and B common look better while not acknowledging the contribution to overall earnings being made by the tracking common. (In addition, the 87.5% "retained interest" that the Class A and Class B common stockholders hold in the tracking stock creates interesting possibilities for "managing" overall EPS by engaging in such activities as (1) unequal stock splits between APOL and UOPX, (2) creative allocation of expenses among the two stock groups, and (3) the selective granting and/or exercise of options associated with one stock group or the other.)

Proof Must Be Absolute

An issuer of tracking stock should not calculate its EPS using the two-class method unless it can prove that its shares of tracking stock have altogether different dividend participation rights than its shares of nontracking stock. Issuers, in conjunction with their lawyers and accountants, are well advised to thoroughly examine what, if any, justification exists under their articles of incorporation and other corporate governance instruments for the assertion that such differing dividend participation rights exist. ■

Robert L. Maddox, Esq., is an executive vice president with Vanderbilt Capital Advisors, LLC, headquartered in New York City. He was graduated from Harvard University cum laude in 1982 and Duke School of Law with honors in 1987. He can be reached at rmaddox@vcallc.com.

1 See SFAS No. 128, "Earnings Per Share," paragraphs 60 and 61, and Illustration 6 in Appendix C to SFAS No. 128.
2 SFAS No. 128 was issued in February 1997 in large part as an attempt to bring U.S. GAAP earnings per share calculations more in harmony with the international standards for calculating EPS set forth in IAS 33. The "Summary" to SFAS No. 128 states that the provisions contained in SFAS No. 128 are substantially the same as those in IAS 33. As a result, the application of SFAS No. 128 in a manner consistent with IAS 33 is an express objective of SFAS No. 128. Paragraph 1 of SFAS No. 128 states: "[t]his Statement's *objective* is to simplify the computation of earnings per share and to make the U.S. standards for computing earnings per share more compatible with the EPS standards of other countries and with that of the IAS Committee." (emphasis added)
3 This convoluted analysis is required by the issuer's use of the fiction that an unincorporated division is in actuality a separate, free-standing corporation.
4 Contained in Apollo's Form 10-K filing with the SEC on November 27, 2002, covering the fiscal year ended August 31, 2002.
5 Contained in Apollo's Form 10-K filing with the SEC on November 27, 2002, covering the fiscal year ended August 31, 2002.
6 Contained as an exhibit to Apollo's filing with the SEC on August 1, 2000, consisting of a definitive proxy statement.
7 Contained in Exhibit 99 to Apollo's Form 10-Q filing with the SEC on July 12, 2002, covering the quarter ended May 31, 2002.
8 In all likelihood, significantly more would be available, but liquid net worth is used as a conservative measure of the total dividend available.