
VALUE WIZARD INSIGHTER - August 2000

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1. World of Money Screen Saver
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An entertaining and informative multimedia screen saver entitled "World of Money" features hotlinks to Value Wizard Investment Models and related websites. One of the links connects to an entry point for Value Wizard Pro Investment Valuation, an upcoming premium edition designed to reach a broader audience with added simplifying features and functionality.

In Value Wizard Pro, it will not be possible to merely put in a ticker symbol and get the intrinsic value of the stock. Such minimal input and output may seem like the ideal but is not realistic. Even with company financial data automatically fetched to populate the input forms, some inputs are individual choices, judgments, forecasts, and personal situation at the time.

The "World of Money" screen saver is less than 1.6 Mb in size, downloads in less than 10 minutes at 28.8 Kbps, is virus-free, and comes in a single install-uninstall binary file. It includes a desktop quick-start button and a tray icon that makes it easily customizable with music (mute), animation, randomized transitions, and password protection.

You are welcome to the "World of Money" screen saver for free, and you may share it with your friends. If interested, contact saver@numeraire.com to receive the current download file name and address.

2. Earnings per Share

Earning per share (EPS) reporting is straightforward except in two situations that more companies are encountering than before. One is a complex capital structure that includes securities that are convertible into common stock. The second is the use of options and warrants as incentive compensation for employees and payment in kind for suppliers of early stage financial capital.

The Accounting Principles Board's APB Opinion No. 15 was the accounting standard for basic, primary and fully diluted earnings per share (EPS) calculations and reporting in financial statements to shareholders. It has been superseded by FASB Statement No. 128 "Earnings per Share" issued February 1997:

<http://www.rutgers.edu/Accounting/raw/fasb/public/index.html>.

"This Statement establishes standards for computing and presenting earnings per share (EPS) and applies to entities with publicly held common stock or potential common stock. This Statement simplifies the standards for computing earnings per share previously found in APB Opinion No. 15, *Earnings per Share*, and makes them comparable to international EPS standards. It replaces the presentation of primary EPS with a presentation of basic EPS. It also requires dual presentation of basic and diluted EPS on the face of the income statement for all entities with complex capital structures and requires a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation.

"Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Diluted EPS is computed similarly to fully diluted EPS pursuant to Opinion 15."

The following article written prior to FASB No. 128 is quoted verbatim in excerpts with bold-face emphasis added. It is recommended that the original short article be read completely.

Relieving the burden of EPS reporting: some practical suggestions.
(earnings per share)

by Mautz, R. David, Jr.

Abstract- Preparers and auditors of financial statements can take steps to avoid the problems caused by the calculation of earnings per share (EPS), which may be the most important item in a financial statement. One problem involving EPS is that it may be replaced on the income statement by two hypothetical EPS calculations: primary EPS and fully diluted EPS. The rules regarding the calculation of primary and fully diluted EPS have been questioned, particularly the test for identifying common stock equivalent securities. The questionable aspects of EPS calculation are mostly the result of incorporating untested or unproven assumptions into accounting standards. The methods of simplifying EPS calculations and eliminating inappropriate assumptions include replacing primary EPS with basic EPS, eliminating the treasury stock method of accounting from fully diluted EPS, eliminating the three-percent test for dual presentation, and providing information on individual dilutive securities.

"Most financial statement readers are familiar with a simple formula for calculating EPS. Earnings available to common share-holders, generally net income minus any preferred dividend requirement, is divided by the weighted average number of common shares outstanding during the year. The resulting statistic is called basic (or simple) EPS. Basic EPS is presented on the income statement when a company has no outstanding securities that are convertible into common stock. When convertible securities are outstanding, more complex rules take effect. These rules are intended to make EPS reflect the potential of convertible securities to dilute earnings available to common shareholders. However, a growing body of thought suggests that the intricate manipulations mandated by APB 15 do little to improve the basic EPS statistic.

"Historical Versus Hypothetical Disclosures. Arguably, the most significant problem with current standards is that basic EPS is subject to replacement on the income statement by two hypothetical EPS numbers. One of those numbers, primary EPS, is computed assuming that **common stock equivalents**, those dilutive securities most similar in substance to common stock, were converted to common stock on the first day of the reporting period. The second number, fully-diluted EPS, is computed assuming that **all dilutive securities** were converted. This computational approach is called the "**if-converted**" method because it produces an estimate of what EPS would be if holders of dilutive securities exercised their rights to obtain common stock. When fully diluted EPS is less than 97% of basic EPS, primary, and fully diluted EPS are the only per share disclosures required under current accounting standards. In other words, historical per share disclosures are completely omitted when potential dilution is material.

"Common Stock Equivalents and Primary EPS. Concerns about the usefulness of dual EPS reporting are not limited to the relative merits of historical and proforma disclosure. Some of the specific rules governing the computation of primary and fully diluted EPS have also been

questioned. The test used to identify common stock equivalent securities is among the most controversial of those rules. Accounting researchers have devoted considerable attention to determining the usefulness of this test and a variety of alternatives. ...

"Options, Warrants, and the Treasury Stock Method. Another questionable aspect of EPS reporting is the **treasury stock method of accounting for option and warrant proceeds**. ...

"The treasury stock method dampens the dilative impact of options and warrants in both the primary and fully diluted EPS calculations. How this device improves the usefulness of per share data is unclear. The accounting literature is devoid of evidence that managers actually use option and warrant proceeds for any of the purposes assumed in accounting standards. The effect of the treasury stock method on financial statement users' decisions is similarly untested. The treasury stock method is, however, partially responsible for our final criticism of EPS reporting.

"Reporting the Range of potential Dilution. The dual EPS reporting format (primary and fully diluted) is an attempt to provide information about the potential dilution of earnings through common stock issuances. In fact, however, possible dilution levels span a range from no assumed dilution, the actual situation at balance sheet date, to maximum assumed dilution, the situation that would have existed had all potential diluters been converted on the first day of the year.

"If dilutive common stock equivalents are outstanding, however, then primary EPS is an undetermined point in the range of potential dilution. Likewise, if options or warrants are outstanding, then the treasury stock method is applied and fully diluted EPS ceases to be the maximum dilution endpoint. Because these two conditions frequently prevail, many public companies' per share disclosures consist of two discrete points within the potential dilution range. Neither the endpoints of the dilution range nor the information needed to calculate EPS assuming various dilution scenarios are required disclosures under generally accepted accounting principles.

"Do these complicated EPS disclosures assist investors and creditors in decision making? The answer is unclear."

I think the multiple EPS and shares outstanding figures are confusing and misleading even for people who are familiar with financial statements and financial accounting standards. These methods can obfuscate any trends of increasing dilution that are damped by the curve-smoothing effects of using weighted averages and moving averages.

3. Shares Outstanding - Continued

This is a continuation of the article on Shares Outstanding in the July 2000 issue of *Insighter* with Yahoo Inc.. as an example. Yahoo's first two quarterly reports for fiscal year 2000 are now filed with the U.S. SEC on Form 10-Q.

In the April 2000 issue of *Insigher*, we reported that Yahoo's market price was well above our optimistic estimate of its intrinsic value of \$95 per share based on fiscal year 1999 Form 10-K information, including the 12 months weighted average of 596,790,000 shares used in per share calculations-diluted.

An adjustment to the total number of shares outstanding due to dilution would improve the accuracy of our estimate of value per share. In the case of Yahoo, the result would be an increase in the number of shares and a corresponding decrease in the estimated value per share. Unless such a revised estimate would result in a value per share for Yahoo *higher* than its current market price, there is no practical need to adjust the total shares outstanding.

We continue our analysis of shares outstanding in order to illustrate such adjustments for cases where they will be needed. For example, say the estimate of intrinsic value is \$100 per share for a given company's common stock, and the market price is \$75 per share. This results in a positive margin of safety of \$25 (\$100 minus \$75) and 25% ($\$25/\100). If the maximum dilution in total shares outstanding at the most recent reporting date is more than 25%, dilution could more than offset this positive safety margin.

In a valuation where the potential dilution exceeds the safety margin, we would want to use a more accurate figure for total shares outstanding and thus a more accurate estimate of intrinsic value per share to see if there remained sufficient margin of safety to considered buying the stock, all other aspects of the stock being acceptable.

Yahoo has no convertible securities outstanding. As stated in the notes to their financial statements, Yahoo common share equivalents primarily result from options and warrants, and Yahoo uses the treasury method of accounting for number of shares outstanding. The dilution of basic EPS for Yahoo is large enough to result in reporting dual EPS, both primary and fully diluted.

In addition, Yahoo does not buy back shares of its common stock in the market place to offset shares issued for the exercise of stock options and warrants, and thus the earnings and cash flow are "diluted" in the sense of being allocated among a larger number of shares outstanding. Instead, Yahoo has used its shares to make strategic acquisitions of other companies. Some of these acquisitions are accounted for by using the pooling of interest method which inhibits share buybacks. Depending on how the transaction was structured, some interpretations of the accounting rules might allow Yahoo to buy back shares.

YHOO Form 10-Q filed 4/14/2000:

YAHOO! INC. Condensed Consolidated Statements of Operations
(unaudited, in thousands except per share amounts)

	Three Months Ended	
	March 31, 2000	March 31, 1999
Net income	\$ 77,851	\$ 1,796
Net income per share---basic	\$ 0.14	\$ 0.00
Net income per share---diluted	\$ 0.13	\$ 0.00
Shares used in per share calculation---basic	538,509	504,048
Shares used in per share calculation---diluted	613,095	594,926

Note 5---Basic and Diluted Net Income per Share

Basic net income per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of the incremental common shares issuable upon the exercise of stock options and warrants (*using the treasury stock method*). For the three month periods ended March 31, 2000 and 1999, common share equivalents approximated 74.6 million and 90.9 million shares, respectively, and were *primarily related to shares issuable upon the exercise of stock options* [italics added].

YHOO Form 10-Q filed 7/28/2000:

YAHOO! INC. Condensed Consolidated Statements of Operations
(unaudited, in thousands except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30, 2000	June 30, 1999	June 30, 2000	June 30, 1999
Net income (loss)	\$ 65,459	\$ (263)	\$143,310	\$1,533
Net income (loss) per share---basic	\$ 0.12	\$ (0.00)	\$ 0.26	\$ 0.00
Net income (loss) per share---diluted	\$ 0.11	\$ (0.00)	\$ 0.23	\$ 0.00
Shares used in per share calculation---basic	547,237	511,812	542,873	507,930
Shares used in per share calculation---diluted	610,005	511,812	611,550	594,244

Note 3---Stock Split

During January 2000, the Company's Board of Directors approved a two-for-one Common Stock split which was effective on February 14, 2000. All share numbers in these condensed consolidated financial statements and notes thereto for all periods presented have been adjusted to reflect the two-for-one Common Stock split.

Note 5---Basic and Diluted Net Income (Loss) Per Share

Basic net income (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of the incremental common shares issuable upon the exercise of stock options and warrants (*using the treasury stock method*) and are excluded from the calculation of diluted net loss per share as their effect is anti-dilutive. For the three and six month periods ended June 30, 2000, common share equivalents approximated 62.8 million and 68.7 million shares, respectively, and were *primarily related to shares issuable upon the exercise of stock options*. For the six month period ended June 30, 1999, common share equivalents approximated 86.3 million shares. [italics added]

Comment and Analysis:

The percent dilution implied by the reported common share equivalents is understated. The tables below show thousands of shares when reported.

End of Period	No. of Months	Shares Basic	Shares Diluted	Common Share Equivalents	Percent Dilution
From 1999 Form 10-K (3-month quarters):					
1Q 1999	3	403,062	474,222	71,160	17.7%
2Q 1999	3	454,922	454,922	-0-	-0-
3Q 1999	3	519,060	592,672	73,612	14.2%
4Q 1999	3	no report	no report	no report	no report

From 2000 Form 10-Q's (3-month quarters):

1Q 2000	3	538,509	613,095	74,586	13.9%
2Q 2000	3	547,237	610,005	62,768	11.5%

Weight Avg	No. of Months	Shares Basic	Shares Diluted	Common Share Equivalents	Percent Dilution
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From 1999 Form 10-K (cumulative weighted average):

1Q 1999	3	403,062	474,222	71,160	17.7%
2Q 1999	6	451,506	451,506	-0-	-0-
3Q 1999	9	511,640	593,720	82,080	16.0%
4Q 1999	12	515,948	596,790	80,842	15.7%

From 2000 Form 10-Q's (cumulative weighted average):

1Q 2000	3	538,509	613,095	74,586	13.9%
2Q 2000	6	542,873	611,550	68,677	12.7%

Reflects the two-for-one stock split effective February 2000.

The reported number of Common Share Equivalents differs between the original 1999 Form 10-K and the subsequent 2000 Form 10-Q's. For the most recent example, the 1999 Form 10-K reports that shares (000's) used in per share calculation-diluted for the six months ending June 30, 1999 is 451,506 (225,753 adjusted for the 2-for-1 stock split in February 2000); whereas, the 2000 2Q Form 10-Q reports that shares (000's) used in per share calculation-diluted for the six months ending June 30, 1999 is 594,244. This is an increase of 142,738 (000) shares or 31.6%.

The same figures (000's) for the three months ending March 31, 1999 are 474,222 (237,111 adjusted for the 2-for-1 stock split in February 2000) and 594,926, an increase of 120,704 or 25.4%. Thus, investors relying on the originally reported share figures would have **overstated value per share by 25% to 32%** for YHOO common.

One reason it is difficult to interpret the data on shares outstanding is that these are not actual historical data. Rather they are hypothetical data that assume different degrees of dilution due to conversion of common share equivalents. Another reason is that this hypothetical dilution is reported differently when the conversion is antidilutive from when it is dilative.

The most conservative number to use for total shares outstanding is to assume all dilative shares are included. Yahoo has options and warrants but no convertible securities outstanding. The Yahoo Inc. 1999 10-K filed 30 March 2000: Item 8: Table 6: Number of Options Outstanding is 124,570(000), or **249,570(000) shares** reflecting the February 2-for-1 stock split.

Therefore, adding 249.57 million shares to the reported end-of-period number of common shares outstanding will result in the maximum dilative shares outstanding as of the end of 1999. The total shares outstanding on 31 December 1999 is 532,756,976 adjusted for the 2-for-1 stock split in February 2000. The 249.57 million is much larger than the 80.842 million common share equivalents derived from the reported 12 months weighted average for 1999, and represents **46.8% dilution** (249.6/532.8). Thus, the maximum total shares outstanding is 782,326,976 on 31 December 1999, or an **additional 31.1% above the 15.7% dilution of the weighted average number of shares used in per share calculation-diluted.**

The most accessible number for shares outstanding, the weighted average number of shares used in per share calculation-diluted, results in an estimated intrinsic value per share *below* current market price. If the estimated value of YHOO was *above* its market price, then it would be appropriate to refine the analysis of intrinsic value, and the 782.327 million shares at maximum dilution may be the next most accessible number of shares to use. If the re-estimated value of YHOO was still *above* its market price, then there would be a positive safety margin that varied with the degree of dilution assumed by the maximum number of shares outstanding.

Our example of YHOO common stock with an estimated intrinsic value of \$95 per share based on 1999 Form 10-K data assumed a hypothetical degree of dilution at 596.790 million shares. Increasing the total shares outstanding to 782.327 million shares would result in a decrease in estimated value per share of about 23.7% $[(782.327-596.790)/782.327 = (185.537/782.327)]$, to an intrinsic value of about \$72 per share $[\$95*(596.790/782.327)]$. This revised value puts YHOO common stock even farther from striking distance of any positive safety margin at prevailing market prices.

At a much lower market price equal to the estimated \$72 per share intrinsic value, some employees have no positive economic incentive to exercise their incentive stock options because the exercise price is higher than the market price. The highest-priced tranche of stock options has exercise prices as of December 31, 1999 from \$73.14 to \$195.13 (\$36.57 to \$97.56 adjusted for the 2-for-1 stock split in February 2000) for 17,510,000 shares out of the total options of 249,140,000 or 7% of total options. Thus, employees granted incentive stock options at the highest exercise price of \$97.56 have a negative incentive of about \$2 per share at an optimistically estimated intrinsic value of \$95 per share.

Yahoo has a relatively large overhang of common equivalent shares primarily due to incentive stock options. Most but not all of the options and warrants probably will be exercised. Not all of the options and warrants will be realized at once because they are vested over five to ten years. If earnings and cash flow materialize at Yahoo soon enough and are large enough, then Yahoo's intellectual capital or labor pool of employees may not financially implode like a Ponzi scheme.

If a company's growth rate in total shares outstanding including dilution continues to exceed the growth rate in total company earnings and cash flow, then EPS-diluted and cash flow per share-diluted will decline. Declining EPS-diluted will not support optimistic double-digit P/E multiples or a lofty speculative stock price, and an implosion could well occur if an external perturbation shocks the company.

Dilution due to common share equivalents is not limited to Internet-related or high-tech companies. Many of the S&P 500 companies have potential share dilution in earnings and cash flow in excess of 10%.

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