Statement of Financial Accounting Standards No. 55

Note: This Statement has been completely superseded

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Determining whether a Convertible Security Is a Common Stock Equivalent

(an amendment of APB Opinion No. 15)

February 1982

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 55 Summary

APB Opinion No. 15, *Earnings per Share*, states that a convertible security is a common stock equivalent if it has a cash yield at the time of issuance of less than 66 2/3 percent of the then current bank prime interest rate. The Board has concluded that the prime rate should be replaced as the benchmark interest rate in the cash yield test. This Statement substitutes the average Aa corporate bond yield as the new benchmark rate.

INTRODUCTION AND BACKGROUND INFORMATION

1. APB Opinion No. 15, *Earnings per Share*, requires that earnings per share computations reflect the dilutive effect of convertible securities. That dilutive effect is computed by assuming that a convertible security was converted into common stock as of the beginning of the period (or at time of issuance, if later). Conversion is assumed for purposes of computing primary earnings per share only if the convertible security is a common stock equivalent and the assumed conversion reduces earnings per share.

2. Opinion 15 discusses several possible tests to determine whether a convertible security is a common stock equivalent. The Accounting Principles Board concluded that the best type of test is a cash yield test. Certain other possible tests of common stock equivalence were rejected as "too subjective and not sufficiently practicable." The cash yield test specifies that a convertible security is a common stock equivalent if the cash yield to the holder at the time of issuance is significantly below what would be a comparable rate for a similar security of the issuer without the conversion option.

3. Paragraph 33 of Opinion 15 describes the specific terms of the cash yield test:

> ...A convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price...it has a cash yield of less than 66 2/3% of the then current bank prime interest rate....

4. The bank prime interest rate was adopted because it was a "practicable, simple, and readily available basis on which to establish the criteria for determining a common stock equivalent" and because at that time there was "a high degree of correlation" between the bank prime interest rate and rates of return on long-term debt and preferred stock.

5. In recent years, the bank prime interest rate has been more volatile than it was in the years preceding the issuance of Opinion 15. In addition, the United States and certain other countries recently have experienced an inverted yield curve, in which short-term interest rates exceed long-term interest rates. During periods of interest rate inversion, the effect of Opinion 15 has been to categorize as common stock equivalents convertible securities with cash yields that are similar to those of comparable securities without a conversion option. The Board does not believe that was the intent of Opinion 15.

6. The Board believes that the disadvantages of using the prime rate to determine whether a convertible security is a common stock equivalent have increased in recent years and more than offset the advantages of practicability, simplicity, and ready availability. Accordingly, the Board has decided to amend the cash yield test of Opinion 15. The Board believes this problem does not warrant a major reexamination of Opinion 15 or of the various methods of determining whether convertible securities are common stock equivalents. Its principal objective in amending the cash yield test is to allow that test to function as the Accounting Principles Board had intended when Opinion 15 was issued. It believes that objective can be satisfactorily achieved if the cash yield test is amended to substitute a new benchmark interest rate.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to APB Opinion No. 15

7. The phrase "bank prime interest rate" in paragraph 33 of Opinion 15 is deleted and replaced by "average Aa corporate bond yield.*"

*The designation Aa refers to the quality of the individual bonds that make up the average yield applied in the cash yield test. In the context of this Statement, the Board intends Aa to refer to bonds of equal quality to those rated Aa by either *Moody's* or *Standard & Poor's.* Those two organizations define Aa bonds as being of high quality and as having a very strong capacity to pay interest and repay principal. Bond yield information is widely and regularly published by a number of financial institutions and investor information services.

For purposes of applying the cash yield test, the *average* bond yield shall be based on bond yields for a brief period of time, for example, one week, including or immediately preceding the date of issuance of the security being tested.

Footnote 10 is deleted and replaced by the following:

If convertible securities are sold or issued outside the United States, the most comparable long-term yield in the foreign country should be used for this test.

Effective Date and Transition

8. The provisions of this Statement shall be applied to determine whether convertible securities issued after February 28, 1982 are common stock equivalents. The provisions of this Statement may, but are not required to be applied to convertible securities issued before March 1, 1982 in fiscal periods for which annual financial statements have not previously been issued.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Walters dissented.

Mr. Walters dissents from the issuance of this Statement because it fine tunes, and thereby perpetuates, a notion that he believes is fundamentally defective.

Information about securities or arrangements that have the potential to significantly dilute share values and cash returns is important to the investor. Accordingly, financial reports must include *factual data* to help the user estimate the probability, timing, and amount of potential dilution. The estimating process is a highly subjective analytical function, not a financial reporting function.

In his opinion, primary earnings per share based on the common stock equivalency notion of APB Opinion 15 does not possess the qualities of relevance and reliability essential to financial information. It is not relevant because it furnishes little or no incremental information about the probability, timing, or amount of potential dilution. It is not reliable, that is, representationally faithful, because it implies imminent or predictable dilution, whereas research suggests that it has been a poor predictor of dilution.

He believes the appropriate Board response is to amend APB Opinion 15 to eliminate the notion of common stock equivalency.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BASIS FOR CONCLUSIONS

9. An Exposure Draft of a proposed Statement, *Determining whether a Convertible Security Is a Common Stock Equivalent,* was issued November 6, 1981. The Board received 68 comment letters in response to the Exposure Draft. This appendix discusses the factors, including certain comments received on the Exposure Draft, that the Board considered significant in reaching the conclusions in this Statement.

10. The Board believes the rate selected as the new benchmark should meet the following criteria: (a) its ability to function as a test of common stock equivalence should not be impaired by changing market conditions of a recurring nature, (b) it should be economically related to yields of corporate convertible securities, and (c) it should be practical to apply. The Board concluded that the existing prime rate benchmark should be replaced with a new benchmark of the average Aa corporate bond yield. That rate was selected because the Board believes it satisfies more of the criteria listed above than do other possible interest rates.

11. Unlike the prime rate, the average Aa corporate bond yield is a long-term rate. It represents the composite yield to maturity of a representative sample of currently outstanding bonds of varying lives, generally from 10 to 30 years. Because it is a long-term rate, its usefulness as a benchmark in the cash yield test is relatively unaffected over time by such factors as interest rate inversion and market turbulence. The susceptibility of the prime rate to those market factors was perceived as a principal shortcoming in its performance as the benchmark rate.

12. The Board also notes that Aa corporate bonds are economically related to corporate convertible securities in that most economic developments that affect yields of Aa corporate bonds will similarly affect yields of convertible securities at the time they are issued. That relationship is consistent with the basic function of the cash yield test, which is to approximate the relationship between the yields of convertible and nonconvertible corporate bonds. The Board believes that economic link adds to the relevance of Aa corporate bond yields as the new benchmark rate.

13. Finally, the Board believes Aa corporate bond yields are "practicable, simple, and readily available." Bond yield quotations are frequently and widely published. The Board selected the Aa category from the various categories of published corporate bond yields because the Aa quotation is among the most widely published.

14. The Board also considered substituting a treasury bond yield for the prime rate in the cash yield test. A treasury bond yield benchmark was rejected, however, because it did not meet criterion (b) of paragraph 10 and, because composite treasury yields are not widely quoted, it was judged less practical to apply than a corporate bond yield.

15. The Board also considered whether it should revise the 66 2/3 percent factor that is applied to the benchmark rate in the cash yield test. The Board concluded that no such change was necessary because the

existing 66 2/3 percent factor, when applied retroactively to the new benchmark of average Aa corporate bond yields, would have produced consistent results with those of Opinion 15 at its inception. The Board has previously stated that achieving this consistency is a principal objective of amending the cash yield test.

16. Some Board members believe that the common stock equivalent information derived under Opinion 15 is not necessarily a relevant or reliable indicator of the dilutive effect of convertible securities on earnings per share data. Nevertheless, they believe there is an urgent need to adopt a more realistic interest rate benchmark for the cash yield test. The Board has concluded that an undertaking to study the concept of common stock equivalency would involve a major reconsideration of Opinion 15. It therefore believes a more limited project addressing only the cash yield test constitutes a better use of the Board's resources at this time.

17. Some respondents recommended that rates other than the average Aa corporate bond yield be used as the new benchmark rate in the cash yield test. Some believe the new benchmark should be the yield on bonds of the specific credit rating of the issuer. They believe that approach satisfies the criteria specified for the new benchmark in paragraph 10 while recognizing that differences in risk exist among the securities of different issuers. The Board rejected that recommendation because the introduction of a benchmark that varies by issuer would require consideration of issues that were not addressed in Opinion 15 and that are beyond the stated scope of this project. It also believes a variable benchmark is not as simple and practical to apply because average yields for rating categories other than Aa are generally not as widely published as Aa yields.

18. The Board similarly rejected other suggested rates because they were judged less successful than the average Aa corporate bond yield at satisfying the criteria in paragraph 10.

19. The Board was asked to consider whether amending the cash yield test results in the need to also amend the second sentence of paragraph 28 of Opinion 15. That sentence requires "convertible securities outstanding or subsequently issued with the same terms as those of a common stock equivalent [to] be classified as common stock equivalents." The Board concluded that the introduction of the Aa benchmark creates no new problem concerning the application of the second sentence of paragraph 28 and that the language should therefore not be amended.

20. The Board concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraph 8 are advisable in the circumstances.