

Statement of Financial Accounting Standards No. 85

Note: This Statement has been completely superseded

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Yield Test for Determining whether a Convertible
Security Is a Common Stock Equivalent

an amendment of APB Opinion No. 15

March 1985



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent

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FAS 85: Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent

an amendment of APB Opinion No. 15

FAS 85 Summary

This Statement amends APB Opinion No. 15, *Earnings per Share*, to replace the "cash yield test" with an "effective yield test" for determining whether convertible securities are common stock equivalents in the primary earnings per share computation.

The Board was asked to consider how the provisions of Opinion 15 should be applied to zero coupon convertible bonds. Since such bonds have no annual cash interest payments, application of the "cash yield test" in Opinion 15 always results in these securities' being considered common stock equivalents. This amendment applies the common stock equivalency test in a manner consistent with the objective of Opinion 15 for a convertible security that pays much or all of its yield at maturity.

The provisions of this Statement shall be applied to convertible securities issued after March 31, 1985, with earlier application encouraged in financial statements that have not previously been issued. Retroactive application for transactions occurring during periods for which financial statements have been issued is permitted.

INTRODUCTION

1. The FASB has been asked to consider how the provisions of APB Opinion No. 15, *Earnings per Share*, should be applied in determining whether a zero coupon convertible bond is a common stock equivalent in the primary earnings per share computation. Because zero coupon convertible bonds have no annual cash interest payments, application of the "cash yield test" in Opinion 15 to convertible securities always results in zero coupon convertible bonds' being considered common stock equivalents. Some contend that this result is inconsistent with both the economic substance of such securities and the objective of Opinion 15.

2. Some have further suggested that the Board not limit its consideration to zero coupon

convertible bonds, contending that the same problem exists with "deep discount" convertible securities, including convertible preferred stock. They believe the Board should replace the "cash yield test" with an "effective yield test" for all convertible securities. The Board agrees and is amending Opinion 15 accordingly.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to APB Opinion No. 15 and Related Pronouncements

3. Paragraph 33 of Opinion 15, as amended by FASB Statement No. 55, *Determining whether a Convertible Security Is a Common Stock Equivalent*, and this Statement, and its related footnotes are to read in their entirety as follows:

A convertible security shall be considered a common stock equivalent if, at the time of issuance, it has an effective yield* of less than 66 2/3% of the then current average Aa† corporate bond yield.‡ The effective yield§ shall be based on the security's stated annual interest or dividend payments,¶ any original issuance premium or discount, and any call premium or discount and shall be the lowest of the yield to maturity and the yields to all call dates. The computation of effective yield does not include considerations of put options or changing conversion rates.

*In computing effective yield, interest shall be compounded on the same basis as publicly traded bonds in the country that the convertible securities are sold or issued. In the United States, interest is generally compounded on a semiannual basis.

†The designation Aa refers to the quality of the individual bonds that make up the average yield applied in the 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 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.

‡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 yield for a security that does not have a stated maturity date shall be computed as the ratio of the security's stated annual interest or dividend payments to its market price at issuance.

¶If the security's stated annual interest or dividend payments are adjustable, effective yield shall be computed based on scheduled formula adjustments and formula information at issuance.

4. The definition of "cash yield" is deleted from Appendix D of Opinion 15, and the parenthetical reference to that definition is deleted from paragraph 35 of Opinion 15. AICPA Accounting Interpretations 34, "Determining a Convertible Security's Cash Yield," and 35, "Computing a Convertible's Cash Yield" of Opinion 15 are deleted. The word *cash* is deleted

from the term *cash yield* in paragraph 35 of Opinion 15 and AICPA Accounting Interpretations 36, "Cash Yield of Convertible Security in a 'Package,'" and 37, "Property Included in Cash Yield," of that Opinion.

Effective Date and Transition

5. The provisions of this Statement shall be applied to convertible securities issued after March 31, 1985. Earlier application of this Statement is encouraged for transactions in fiscal periods for which annual financial statements have not previously been issued. Furthermore, retroactive application of this Statement to transactions occurring during fiscal periods for which annual financial statements have previously been issued is permitted, in which case the effects on restated per share amounts of prior periods shall be disclosed. In determining whether a security issued prior to the adoption of Statement 55 was a common stock equivalent at issuance, effective yield shall be compared to 66 2/3% of the then current prime interest rate.

**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. Block dissented.

Mr. Block dissents from this Statement because he believes that the timing, probability, and degree of dilution are a complex problem in financial analysis. In addition, empirical evidence suggests that a cash yield, effective yield, or any other simple test fails to identify convertible securities that are likely to be dilutive. He believes the appropriate Board response is to amend Opinion 15 to eliminate the notion of common stock equivalency. Primary earnings per share would then be calculated on average common shares actually outstanding. He also believes that fully diluted earnings per share should be retained as a useful warning signal.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
Raymond C. Lauer
David Mosso
Robert T. Sprouse
Arthur R. Wyatt

Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

6. An Exposure Draft of a proposed Statement, *Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent*, was issued on December 6, 1984. In response to the Exposure Draft the Board received 53 comment letters, most of which expressed agreement. This appendix discusses the significant comments received during the exposure period and the factors deemed significant by the Board in reaching the conclusions in this Statement. Individual Board members gave greater weight to some factors than to others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing and that the effective date specified in paragraph 5 is advisable in the circumstances.

7. Opinion 15 requires that earnings per share computations reflect the dilutive effect of convertible securities, which is computed by assuming that a convertible security was converted into common stock as of the beginning of the period (or at the 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.

8. Paragraph 33 of Opinion 15, as amended by paragraph 7 of Statement 55, 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 average Aa corporate bond yield. [Footnote references omitted.]

9. In recent years, debt instruments that do not pay any interest until maturity, known as zero coupon bonds, have emerged. In response to corporate and investor demand, the notion of zero coupon convertible securities has also emerged. This development raised the accounting question of whether zero coupon convertible securities should always be considered common stock equivalents in the computation of earnings per share of the issuer, as would be required in applying the "cash yield test" specified by paragraph 33 of Opinion 15.

10. The Board agrees that the result of applying the "cash yield test" to a zero coupon or a low coupon convertible security is inconsistent with the economic substance of the security. The Board believes that the objective of Opinion 15 was to identify securities that have a yield to the holder at issuance significantly below the yield of a similar security of the issuer without the conversion option.

11. The Board has decided to amend Opinion 15 and replace the "cash yield test" with an "effective yield test." The Board believes this change, which takes into account any original

issuance premium or discount and any call premium or discount, is theoretically preferable. It also makes the test rate more comparable with the Aa benchmark rate adopted for the test by Statement 55, which is based on yield to maturity.

12. The Board recognizes that in certain instances a security's effective yield to a call date may be lower than its effective yield to maturity. The Board concluded that the lower of the yields should be used in this test when that occurs. Consideration was also given to whether effective yield to a "put" date should be part of this test. The Board agrees that a put option, a unilateral right of the holder to demand redemption, can affect the investment value of a convertible security. However, the Board believes that the nature of the option, a right to terminate the debt investment for cash, is not consistent with the notion of common stock equivalency. Additionally, the Board believes that determining the limited circumstances when use of effective yield to a put date is appropriate would be difficult in practice. For those reasons, the Board concluded that effective yield to a put date should not be part of this test.

13. Opinion 15 discusses a convertible security that has a changing conversion rate. For example, an issue may be convertible into one share of common stock in the first year, 1.10 shares in the second year, and 1.20 shares in the third year, and so forth. Frequently, these securities receive little or no cash dividends. Therefore, their value is derived principally from their conversion feature and would be deemed to be a common stock equivalent under the "cash yield test." This Statement does not change that conclusion or any other conclusions or provisions of Opinion 15 not specifically addressed in this Statement. Yield associated with changing conversion rates does not enter into the computation of effective yield, and the Board has expressly excluded it.

14. Some respondents suggested that the Board respond to this issue by amending Opinion 15 to eliminate the notion of common stock equivalency. They believe that primary earnings per share should be calculated on average common shares actually outstanding. Some other respondents raised the concern about a determination that a security is a common stock equivalent based on relationships existing at the date of issuance, and that precludes consideration of subsequent relationships during the period the convertible securities are outstanding. The Board recognizes these recurrent concerns but believes that this narrow issue does not warrant a major reexamination of Opinion 15 or the various methods of determining whether convertible securities are common stock equivalents. Further, the Board believes that an "effective yield test" is more appropriate than a "cash yield test," especially for convertible securities issued at a significant discount.

15. Several respondents suggested that the final Statement should permit, but not require, retroactive implementation and restatement of previously issued financial statements for transactions occurring in periods previously reported so that similar transactions can be reported similarly. The Board concurs with that recommendation and has modified the Statement accordingly.