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Theory and Practice: Current Studies and Concepts

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THEORY AND PRACTICE

Current Studies and Concepts

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EARNINGS PER SHARE

In the March 1969 issue the "Exposure Draft—Proposed APB Opinion: Earnings Per Share" was discussed. The exposure draft was issued by the Accounting Principles Board of the American Institute of Certified Public Accountants for comment from persons interested in financial reporting. The Board has now issued its official Opinion on this subject—APB Opinion No. 15. The Opinion reflects significant changes from the exposure draft. It was adopted by the assenting votes of fifteen members of the Board of whom five assented with qualification. Three members dissented.

Because of the Opinion's length, (25 pages), it will be discussed in this column in two installments. This issue will discuss its effective date, the financial statements to which it applies, the securities that it covers and their presentation in financial statements. The November issue will discuss the earnings per share disclosures required in financial statements in the presence of simple capital structures and those required in the presence of complex capital structures. It will also discuss the periods for which such disclosures are required and when supplementary earnings per share information should be given. Some of the differences from APB Opinion No. 9, the previously issued Opinion on this subject, and from the exposure draft will be pointed out.

Neither this issue nor the November issue will discuss the reasons for the qualified assents and the dissents, nor the Opinion's four appendices. The latter cover 33 pages and contain computational guidelines, a summary of differing viewpoints, illustrative statements and definitions of terms.

The Opinion is very complex. To be fully understood, it should be read and studied in depth.

Effective date

The Opinion is effective for fiscal periods beginning after December 31, 1968, except as follows. Early compliance is recommended, as is consistent retroactive application.

To permit a transition to the provisions of the new Opinion, but to avoid a requirement for retroactive application, each company is to make the following election (not to be subsequently changed) as of May 31, 1969 with respect to all securities issued prior to June 1, 1969 for the *purpose of computing primary earnings per share:*

(a) determine the classifications of *all* such securities under the provisions of the new Opinion, or

(b) classify as common stock equivalents only those securities which are classified as residual securities under Opinion No. 9, regardless of their classifications under the new Opinion.

If option (a) is selected, computations of earnings per share data—both primary and fully-diluted—are to be based on the new Opinion for all periods presented, *including prior periods.*

If option (b) is selected, the computation of primary earnings per share data for all periods —prior and future—is to be made by "freezing" the residual status of *all* securities outstanding at May 31, 1969 as classified under Opinion No. 9 at that date—including options and warrants. (Securities issued subsequent to May 31, 1969 are to be classified under the new Opinion, for all computations.) If option (b) is selected, the computation of fully-diluted earnings per share data for fiscal periods beginning after December 31, 1968 are to be based on the provisions of the new Opinion; those for prior periods on the basis of Opinion No. 9.

Applicability

The Opinion applies to financial presentations which purport to present results of operations of corporations in conformity with generally accepted accounting principles and to summaries of those presentations, except as stated in the following paragraph. Thus, it applies to corporations whose capital structures include only common stock or common stock and senior securities and to those whose capital structures also include securities that should be considered the equivalent of common stock i.e. common stock equivalents in computing earnings per share data.

The Opinion does not apply to mutual companies that do not have outstanding common stock or common stock equivalents (for example, mutual savings banks, cooperatives, credit unions, and similar entities), to registered investment companies, to government-owned corporations, or to nonprofit corporations. The Opinion also does not apply to parent company statements accompanied by consolidated financial statements, to statements of wholly-owned subsidiaries, or to special purpose statements.

Common stock equivalents

Convertible securities

One of the most significant changes in the Opinion is the Board's conclusion that *determination of whether a convertible security is a common stock equivalent* (use of the term residual securities was discontinued) *should be made only at time of issuance* and should not be changed thereafter so long as the security remains outstanding. The exposure draft had provided for such determination to be made at time of issuance and after issuance. This also was being done in practice under interpretations of provisions of Opinion No. 9.

The Opinion also provides that convertible securities outstanding or subsequently issued with the same terms of those of a common stock equivalent also should be classified as common stock equivalents.

Another significant change from the exposure draft is in the criteria for determining common stock equivalency of convertible securities.

Opinion No. 15 provides that *a convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price* (if no market price is available, this test should be based on the fair value of the security), *it has a cash yield of less than 66⅔% of the then current bank prime interest rate.* For any convertible security which has a change in its cash interest rate or cash dividend rate scheduled within the first five years after issuance, the lowest scheduled rate during such five years should be used in determining the cash yield of the security at issuance.

In this Opinion the Board concluded that the investment value test for determining common stock equivalency, which has been in use since issuance of Opinion No. 9, and the market parity test, which was put forth in an addendum to the exposure draft because of the belief by some Board members that it was preferable to the investment value test, were too subjective and not sufficiently practicable.

Options and warrants

The Opinion states that *options and warrants* and similar arrangements usually have no cash yield and derive their value from their right to obtain common stock at specified prices for an extended period. *Accordingly, they should be regarded as common stock equivalents at all times.* However, as a practical matter, the Board recommends that assumption of exercise not be reflected in earnings per share data until the market price of the common stock obtainable has been in excess of the purchase price for substantially all of three consecutive months ending with the last month of the period to which earnings per share data relate. With certain limitations, the Opinion provides that the "treasury stock" method should be used to determine the amount of dilution to be reflected in earnings per share data.

These provisions differ from those in the exposure draft. That draft provided different criteria for determination of the common stock equivalency of options and warrants. It also indicated that use of the treasury stock method to determine the amount of dilution to be reflected in earnings per share data was inappropriate. Opinion No. 9 did not specifically cover the common stock equivalency of options and warrants.

Other securities

The Opinion provides, as did the exposure draft, that participating securities and two-class common stocks may under certain circumstances be common stock equivalents. It also provides that shares contingently issuable upon the mere passage of time (or held in escrow pending the satisfaction of conditions unrelated to earnings or market value) should be considered as outstanding in the computation of primary earnings per share.

Treatment of common stock equivalents in financial statements

The Opinion states that the designation of securities as common stock equivalents in the Opinion is solely for the purpose of determining primary earnings per share. It states that no changes from present practices are recommended in the accounting for such securities, in their presentation within financial statements or in the manner of determining net assets per share.