



**International  
Accounting Standards  
Board**

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*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**Board Meeting: January 2006, London**

**Project: Earnings Per Share – Treasury stock method (Agenda Paper 3)**

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### **Introduction**

1. At the November 2005 Board meeting, the Board decided to amend IAS 33 *Earnings Per Share*. This amendment requires a change to the definition of assumed proceeds when using the treasury stock method. This would ensure consistency with the proposed amendment to FASB Statement No. 128 *Earnings Per Share*.
2. At the November Board meeting, the Board was asked to consider whether the treasury stock method should also be used to calculate the dilutive effect of convertible instruments on Earnings Per Share (EPS) calculations. This would replace the 'if converted' method that is used at present.
3. The Board decided in principle that this method should also be used for convertible instruments. However, the Staff was requested to conduct further analysis on this matter.

## **Earnings Per Share – Treasury stock method**

4. The purpose of this paper is to provide analysis for the Board to determine whether the treasury stock method should be applied to all convertible instruments.

### **Staff Recommendation**

5. The Staff recommends that the treasury stock method is applied to the calculation of the dilutive effects of all convertible instruments on EPS.

### **Staff Analysis**

6. The Board decided to amend IAS 33 in line with FASB's decision to change the assumed proceeds for the treasury stock method in calculating the dilutive effect of options, warrants and their equivalents.
7. However, the FASB decided not to extend the use of the treasury stock method to all convertible instruments until completion of their 'liabilities / equity' project. [Not reproduced in observer notes]. The FASB did not note any conceptual reason as to why the treasury stock method should not be applied to convertible instruments.

### *Treasury stock*

8. The treasury stock method is a term used in connection with diluted EPS calculations. The current version of IAS 33 uses a form of the treasury stock method to compute the dilutive effects of options, warrants and their equivalents.
9. An entity applies the treasury stock method in the following way in calculating diluted EPS in accordance with paragraph 45 of IAS 33:
  - (a) An entity assumes the exercise of dilutive options and warrants of the entity.
  - (b) The assumed proceeds from the instruments are regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period.

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- (c) The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period is treated as an issue of ordinary shares for no consideration.
10. The shares issued for no consideration are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted EPS. Example 5 of the Illustrative Examples accompanying IAS 33 shows the effects of share options on diluted EPS.
11. Options and warrants have a dilutive effect only when the average market price of ordinary shares during the period exceeds the exercise price of the options or warrants (ie they are ‘in the money’).
12. IAS 33 does not define what assumed proceeds are but it does state that the assumed proceeds would include:
- (a) the issue or exercise price of the options or warrants, plus
  - (b) the fair value of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangements, for share options and other share-based payment arrangements to which IFRS 2 *Share-based Payment* applies.<sup>1</sup>
13. The changes proposed to IAS 33 agreed at the November Board meeting now amend the assumed proceeds to include the carrying value of the liability or senior equity converted.
14. This change to the treasury stock method affects the denominator of the EPS equation. Conversion of dilutive options and warrants is assumed at the beginning of the period or, if later, the issue date of the options and warrants. The proceeds from conversion are assumed to be any consideration that would have been received on conversion and the carrying value of the options and warrants converted. These proceeds are assumed to be used to purchase shares at the average market price for

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<sup>1</sup> Paragraph 47A of IAS 33 and Illustrative Examples 5 and 5A accompanying IAS 33

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the period. The incremental shares (the difference between the shares from conversion and the shares at average market price) are included in the diluted EPS denominator.

15. The overall effect of the change proposed to the treasury stock method is as follows:

<b>IAS 33 and SFAS 128</b>	<b>Amended treasury stock method</b>
Denominator effect: Options, warrants and equivalents have a dilutive effect if the average market price of an entity's shares exceeds the exercise price of the options or warrants (the exercise price includes the fair value of goods or services to be supplied to the entity under a share-based payment arrangement, and for US GAAP purposes, any tax benefit that would be credited to equity on exercise of the options). The dilutive effect in terms of number of shares is added to the denominator in calculating diluted EPS.	Denominator effect: In many cases (in particular when the share price of an entity is increasing), options, warrants and equivalents that are classified as liabilities, carried at fair value, and potentially settled in shares would have no dilutive effect and therefore, would not affect the calculation of diluted EPS.
Numerator effect: The numerator would be adjusted for any items related to dilutive warrants, options or equivalents deducted in arriving at profit or loss attributable to ordinary shareholders (eg fair value changes related to the liability element of dilutive warrants or options). <sup>2</sup>	Numerator effect: There would be no numerator adjustment.

16. Use of the treasury stock method allows any dilution to be shown as the marginal increase in the ordinary shareholdings as a result of potentially convertible instruments.

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<sup>2</sup> Paragraph 33 of IAS 33 requires such an adjustment in determining the numerator in a diluted EPS calculation.

## **Earnings Per Share – Treasury stock method**

17. A criticism of the treasury stock method is that it assumes management will use the proceeds on conversion of an instrument to repurchase ordinary shares. It is suggested that often this would not reflect reality.

### *Current methodology – convertible instruments*

18. Currently, the 'if-converted' method is used to calculate the dilutive effects of convertible instruments. This method affects both the numerator and the denominator of the EPS calculation.
19. It assumes that convertible instruments are treated as having been converted at the beginning of the period to which they were outstanding or, if later, the issue date of the instrument. The numerator is adjusted for any interest or dividends related to the convertible instrument. There is no adjustment made for the extinguishment of the debt component that would occur if the instrument were converted to shares. The shares that would have been issued, were the instrument converted, are included in the EPS denominator.
20. The continued use of this method would create an inconsistency between options, warrants and their equivalents and convertible instruments. Further, it is punitive to an entity's diluted EPS calculation as it does not assume any benefit from the discharge of obligations or redemption of senior equity.

### *US GAAP convergence*

21. By extending the use of the treasury stock method to convertible instruments, the IASB will create a divergence from US GAAP. The principle reason for the change to the treasury stock method was to achieve convergence with US GAAP.
22. The Board noted at its November Board meeting that divergence from US GAAP should not preclude extending the use of the treasury stock method. This is because the accounting for convertible instruments in accordance with US GAAP is

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different to the requirements in IAS 32 *Financial Instruments: Disclosure and Presentation*.<sup>3</sup>

### *Recommendation*

23. Extending the proposed treasury stock method to convertible instruments removes an inconsistency within IAS 33 between the manner in which options, warrants and their equivalents are treated compared to convertible instruments. This change would improve the standard by making the diluted EPS calculation simpler.
24. [Not reproduced in observer notes]. As such, it is recommended that the use of the treasury stock method be extended to convertible instruments.

### *Revisions proposed to IAS 33 Earnings Per Share*

25. [Not reproduced in observer notes].
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<sup>3</sup> Convertible instruments are recognised as a liability in accordance with US GAAP. In accordance with IFRSs, convertible instruments are separated into a debt component and an equity component. The debt component is recognised as a liability; the equity component is recognised as equity.